

2008

## Foreclosure Reform Amid Mortgage Lending Turmoil: A Public Purpose Approach

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### Recommended Citation

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# ARTICLE

## FORECLOSURE REFORM AMID MORTGAGE LENDING TURMOIL: A PUBLIC PURPOSE APPROACH

*Prentiss Cox\**

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\* Associate Professor of Clinical Law, University of Minnesota Law School. The Author thanks Donald Brewster for his generosity in sharing his extraordinary database of resources and tremendous knowledge. The Author also thanks Ann Burkhart, Brett McDonald, and Jeff Crump for their helpful advice, and Jon Taylor for his timely and excellent research assistance.

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## I. INTRODUCTION

Irene Thomas was twenty-one years old when she met a man outside of a nightclub who convinced her that she could make money in real estate.<sup>1</sup> A mortgage broker and others used her credit rating to obtain ten residential properties within a ninety-day period with no money down.<sup>2</sup> Ms. Thomas incurred \$2.4 million in mortgage debt for these home purchases.<sup>3</sup> Just over a year later, all the properties were in foreclosure after Ms. Thomas failed to make the mortgage payments.<sup>4</sup> The neighborhood on the north side of Minneapolis where these ten properties are located has been wracked by an approximately five-fold increase in foreclosures that has led to abandoned homes and neighborhood deterioration.<sup>5</sup> In north Minneapolis alone there have been 1,400 houses sold through foreclosure auctions.<sup>6</sup> Much of the problem in north Minneapolis involves foreclosure of rental investment property,<sup>7</sup> which resulted in deteriorated housing quality in the neighborhood. Ms. Thomas now has ruined credit because she was duped by those who sold her homes at inflated prices.<sup>8</sup>

Franklin and Beryl Abazie bought a home in Newark using two subprime mortgage loans.<sup>9</sup> Mr. Abazie took a second job at a state mental hospital in an attempt to make the payments on the loans.<sup>10</sup> After giving birth to their first child, Mrs. Abazie returned to work at a home for the elderly.<sup>11</sup> The family also found a tenant to help pay the mortgage.<sup>12</sup> Ultimately, the monthly payments on the loans overwhelmed the Abazie family, and their mortgage went into foreclosure.<sup>13</sup> The Newark neighborhood in which the Abazie family lives is covered with

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1. Pam Louwagie & Glenn Howatt, *"Straw Buyer" Deals Fuel Tidal Wave of Foreclosures*, STAR TRIB. (Minneapolis), June 10, 2007, at A1.

2. *Id.*

3. *Id.*

4. *Id.*

5. The five-fold increase is reflective of the data provided by the Hennepin County Sheriff's Office. This data can be accessed at <http://www4.co.hennepin.mn.us/webforeclosure/>.

6. Pam Louwagie & Glenn Howatt, *Foreclosure Epidemic*, STAR TRIB. (Minneapolis), May 5, 2007, at A1.

7. *Id.*

8. See Louwagie & Howatt, *supra* note 1.

9. Kareem Fahim & Ron Nixon, *Behind Foreclosures, Ruined Credit and Hopes*, N.Y. TIMES, Mar. 28, 2007, at A1.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

signs that say "Avoid Foreclosure" or "Sell Your Home," symptoms of a foreclosure crisis.<sup>14</sup>

The explosive growth and recent collapse of the subprime mortgage lending industry has led to an increase in mortgage foreclosures that will persist for years.<sup>15</sup> Rising foreclosures have started to blight certain areas of American cities hit hardest by the problem.<sup>16</sup> As the consequences of rising foreclosure become apparent in the form of deteriorating neighborhoods, state legislatures are looking to reform foreclosure law.<sup>17</sup>

State foreclosure laws have developed over centuries, and the rights of the borrowers and the lenders vary widely between jurisdictions.<sup>18</sup> In Georgia, property can be sold at auction within two months of the initiation of the foreclosure.<sup>19</sup> In Indiana, the foreclosure process must occur through court action and takes a minimum of almost nine months.<sup>20</sup> Each state has its own array of notice requirements, sale procedures, and borrower protections prior to or after the sale.<sup>21</sup> Yet there are few distinctions in the

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14. *Id.*

15. See *infra* notes 26–55 and accompanying text (describing the nature of the recent subprime mortgage crisis).

16. See NEIGHBORHOOD HOUS. SERVS. OF CHI., INC., PRESERVING HOMEOWNERSHIP: COMMUNITY-DEVELOPMENT IMPLICATIONS OF THE NEW MORTGAGE MARKET 13–20 (2004), available at <http://www.nw.org/network/neighborworksProgs/foreclosuresolutionsOLD/documents/preservingHomeownershipRpt.pdf> [hereinafter NEIGHBORHOOD HOUSING] (recommending changes in state foreclosure laws to address the rising number of foreclosures).

17. See National Conference of State Legislatures, 2007 Foreclosure Legislation, [http://www.ncsl.org/standcomm/scomm/Foreclosures\\_2007.htm](http://www.ncsl.org/standcomm/scomm/Foreclosures_2007.htm) (last visited Sept. 5, 2008) (listing 28 state legislatures with proposed legislation addressing some aspect of foreclosure law).

18. See, e.g., Debra Pogrud Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 643–48 (1997) (detailing the advantages to lenders and borrowers in different kinds of foreclosures).

19. GA. CODE ANN. § 44-14-180 (2007); see also THE NATIONAL MORTGAGE SERVICER'S REFERENCE DIRECTORY 89 (22d ed. 2005) [hereinafter MORTGAGE DIRECTORY] (estimating that a foreclosure sale can occur in as little as thirty-seven days from referral of file to foreclosing attorney); Vikas Bajaj, *Increasing Rate of Foreclosures Upsets Atlanta*, N.Y. TIMES, July 9, 2007, at A1 ("Georgia's foreclosure laws have also accelerated a process that can drag on for months in legal proceedings in other states. Lenders can declare a borrower in default and reclaim a house in as little as 60 days.").

20. IND. CODE § 32-29-7-3 (2007); see also MORTGAGE DIRECTORY, *supra* note 19, at 1-105, 1-108 (estimating a minimum of 266 days to complete the foreclosure process).

21. Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109, 1112 (1996). ("[L]and laws in individual states developed to reflect the special political values that the citizens of those states held."); see also JOHN RAO, ODETTE WILLIAMSON & TARA TWOMEY, FORECLOSURES: DEFENSES, WORKOUTS AND MORTGAGE SERVICING § 1.3.1.2, app. C (2d ed. 2007) (noting that each state has its own foreclosure laws and detailing the provisions for each state).

various state laws between foreclosing on the multiple loans for the ten properties bought and abandoned by Irene Thomas and foreclosing on loans to homeowners like the Abazie family.

Part II of this Article describes the origin, scope, and consequence of rising foreclosures. Part III provides an overview of the law governing mortgage foreclosure, which is predominantly a matter of divergent state statutes. This Part also discusses the reality for homeowners and lenders in the foreclosure process. Part IV examines the current commentaries on foreclosure law. Legal scholars have focused particular attention on the foreclosure sale mechanism and proposals for alternate sale procedures, often cleverly conceived, that arguably would provide for more efficient outcomes for the parties or the broader market.

The principal argument in this Article is that state foreclosure laws should reflect broader public interests in housing policy, not just a balancing of the competing interests of the parties to mortgage default. In particular, reform of state foreclosure laws can be a tool in ameliorating homeownership loss and stabilizing neighborhoods hardest hit by foreclosures. Part V discusses the relationship between foreclosure laws and these national housing policy goals. Focusing on broader public policy goals provides a different focus on foreclosure law reform than prior discourse in this area.

Part VI advocates two fundamental types of reform of state foreclosure laws. Subpart A argues for a bifurcation of foreclosure procedures by property type. Lenders should be able to expeditiously foreclose on investor property, including residential property not owner-occupied. Homeowners who occupy residential property should be given longer reinstatement periods, and redemption periods should be replaced with reinstatement rights. The Abazie family should be given every opportunity to maintain ownership of their home, while there is little reason to prolong the foreclosure process to protect the interests of Irene Thomas in her ten properties. Subpart B advocates new notice provisions that would change the content, frequency, and public filing requirements of state foreclosure laws. Finally, Subpart C describes the advantage of this more flexible approach to foreclosure reform rather than the multiple unsuccessful attempts at enacting uniform state laws.

## II. RISING MORTGAGE FORECLOSURES IN THE UNITED STATES

Not since the Great Depression of the 1930s has mortgage foreclosure been a significant topic of public discussion. This is no

doubt true because foreclosure rates are creeping toward Depression-era levels.<sup>22</sup> The increase in mortgage defaults and foreclosures are causing distress in the financial markets.<sup>23</sup> The Federal Reserve Board and its chairman, Ben Bernanke, have issued a series of statements in an effort to calm concerns about widespread financial turmoil caused by the increase in defaults and foreclosures.<sup>24</sup> The investment banking industry, which issues mortgage-backed securities, is scrambling to decode the magnitude of losses and the effect on the market.<sup>25</sup>

Subpart A briefly describes the subprime lending practices that primarily have caused increasing foreclosures. Subpart B details the effect of rising mortgage foreclosure rates on certain communities, including a detailed description of the increase in foreclosures in Minneapolis, Minnesota, as an example of the problem.

#### A. *Rising Foreclosures and the Subprime Lending Connection*

There is no comprehensive and authoritative source for data on foreclosures.<sup>26</sup> Yet however measured, the number and rate of

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22. Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. TIMES, Sept. 2, 2007, § 3 (Sunday Business), at 1.

23. See Deborah Solomon, *Bush Moves to Aid Homeowners*, WALL ST. J., Aug. 31, 2007, at A4 (discussing turmoil in the market caused by foreclosures and the political response).

24. Ben S. Bernanke, Chairman, Fed. Reserve Bd., Remarks Made at the Federal Reserve Bank of Kansas City's Economic Symposium (Aug. 31, 2007) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm>); Ben S. Bernanke, Chairman, Fed. Reserve Bd., The Housing Market and Subprime Lending, Remarks via satellite to the 2007 International Monetary Conference (June 5, 2007) [hereinafter Bernanke, Housing Market] (transcript available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20070605a.htm>); Ben S. Bernanke, Chairman, Fed. Reserve Bd., The Subprime Mortgage Market, Remarks at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007) [hereinafter Bernanke, Subprime Market] (transcript available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20070517a.htm>).

25. See, e.g., AM. SECURITIZATION FORUM, STATEMENT OF PRINCIPLES, RECOMMENDATIONS AND GUIDELINES FOR THE MODIFICATION OF SECURITIZED SUBPRIME RESIDENTIAL MORTGAGE LOANS 1 (2007), [http://www.americansecuritization.com/uploadedFiles/ASF\\_Subprime\\_Loan\\_Modification\\_Principles\\_060107.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Subprime_Loan_Modification_Principles_060107.pdf) [hereinafter FORUM] (noting the "broader environment for subprime loans: an increase in delinquency, default and foreclosure rates; a decline in home price appreciation rates; a prevalence of loans with a reduced introductory rate that will soon adjust to a higher rate; and a reduced availability of subprime mortgage lending for refinancing purposes"); Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds are Worth Little*, N.Y. TIMES, July 18, 2007, at C2.

26. THE CTR. FOR STATISTICAL RESEARCH INC., U.S. MORTGAGE BORROWING: PROVIDING AMERICANS WITH OPPORTUNITY, OR IMPOSING EXCESSIVE RISK? 11-12 (2007), available at <https://www.afsaonline.org/CMS/fileREPOSITORY/Foreclosure%20Study%20CSR%20May%202007%20FINAL.pdf> [hereinafter MORTGAGE BORROWING] (describing

foreclosures has been rising over the last ten years and especially recently. The number of mortgages entering foreclosure rose from 0.35% in the second quarter of 1997<sup>27</sup> to 0.99% in the first quarter of 2008, which was the highest foreclosure rate in more than twenty-five years.<sup>28</sup>

Subprime lending has driven this rise in foreclosures.<sup>29</sup> Subprime loans are designed for borrowers who have characteristics that suggest a poorer credit risk.<sup>30</sup> Subprime borrowers pay higher interest rates, higher loan fees, or both, in order to compensate lenders for the greater risk of default.<sup>31</sup> Only 14% of mortgages are subprime loans, yet subprime loans constitute over 64% of the loans in foreclosure.<sup>32</sup>

Subprime lending has long been associated with deceptive and unfair sales practices.<sup>33</sup> State attorneys general cooperated in a series of cases against some of the largest subprime mortgage lenders, alleging violations of consumer protection laws. These cases resulted in settlements costing these lenders approximately \$850 million in restitution to homeowners.<sup>34</sup> Subprime lending

the three most common means of measuring the number of foreclosures and the rate of change in foreclosure activity). There is some indication that the most commonly cited sources may grossly undercount foreclosures. *See, e.g.*, Steve Alexander & Jim Buchta, *Foreclosures Taking a Bigger Toll Across Minnesota*, STAR TRIB. (Minneapolis), Aug. 2, 2007, at D1 (reporting that the 11,207 actual count of foreclosure sales in Minnesota in 2006 were almost twice the number reported by RealtyTrac based on mortgage industry reporting).

27. *See* U.S. Dep't of Housing & Urban Dev., *U.S. Housing Market Conditions National Data: Housing Finance*, Fall 1997, available at [http://www.huduser.org/periodicals/USHMC/fall97/nd\\_hf.html](http://www.huduser.org/periodicals/USHMC/fall97/nd_hf.html) (reporting the MBA delinquency survey for the 2Q of 1997).

28. Press Release, Mortgage Bankers Assoc., *Delinquencies Decrease in Latest MBA National Delinquency Survey* (June 14, 2007), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/55132.htm> (announcing the results of the MBA national delinquency survey).

29. *See* CTR. FOR RESPONSIBLE LENDING, *A SNAPSHOT OF THE SUBPRIME MARKET 1* (2007), <http://www.responsiblelending.org/pdfs/snapshot-of-the-subprime-market.pdf>.

30. Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-based Pricing*, 44 HARV. J. ON LEGIS. 123, 126 (2007).

31. *See id.* at 126–27 (observing that the amount of higher loan rates and charges are theoretically correlated to the risk presented by the borrower's characteristics, but loan pricing does not always follow this model in practice).

32. CTR. FOR RESPONSIBLE LENDING, *supra* note 29, at 3.

33. *Up to 25% of Subprime Losses Blamed on Fraud*, INSIDE B & C LENDING, Nov. 5, 2007, at 5 (finding indications of fraud in almost every subprime loan file examined); *see* Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407–08, 413–14 (2007) (describing skepticism toward subprime lending and the congressional response).

34. *See, e.g.*, Michelle Singletary, *Taming the Predators*, WASH. POST, Jan. 29, 2006, at F1 (noting the \$325 million dollar settlement with Ameriquest and the agreement to avoid predatory practices); Mark Skertic, *Household Settles Class-action Suits for \$100 Million*, CHI. TRIB., Nov. 26, 2003, § 3, at 1 (stating that the lender had reached a \$484



has been associated with interest rates and loan fees disproportionate to the risk of the loan, deceptive representations as to the terms of the loans, appraisals inflated beyond fair market value, servicing abuses, and a range of other unfair and deceptive practices.<sup>35</sup>

The vast majority of subprime mortgage loans are sold by the entity that originates the loan into the secondary market for “mortgage-backed securities.”<sup>36</sup> This shifting of risk from the originator of the loan to investors in securities comprised of these loans fueled the rapid expansion of the subprime market.<sup>37</sup> Unfortunately, securitization has also likely encouraged many of the unfair and deceptive practices.<sup>38</sup> The regulatory structures erected in previous generations, including disclosure requirements and bank supervision, do not fit well with and do not effectively control the problems created in a world of expansive mortgage lending, especially when that lending occurs through securitized financing.<sup>39</sup>

While foreclosure rates vary by region, the relationship between subprime lending and drastically higher foreclosure rates is well established.<sup>40</sup> Subprime mortgages accounted for

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million settlement with state Attorneys General); Press Release, Fed. Trade Comm’n, Subprime Loan Victims to Receive Consumer Redress (Dec. 19, 2002) (stating that \$60 million or more would be distributed to homeowners as a result of settlement between First Alliance Mortgage Company and the Federal Trade Commission, state attorneys general, and private plaintiffs). The Author notes that he was substantially involved in the leadership of all of these cases as an assistant attorney general in the Minnesota Attorney General’s Office.

35. See Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL’Y DEBATE 753, 756–61 (2004) (describing servicing abuses in the subprime mortgage industry); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2043–45 (2007) (giving examples of predatory lending practices).

36. Engel & McCoy, *supra* note 35, at 2045.

37. *Id.* at 2045, 2049.

38. THE REINVESTMENT FUND, MORTGAGE FORECLOSURE FILINGS IN PENNSYLVANIA 71–72 (2005), <http://www.trfund.com/resource/downloads/policypubs/Mortgage-Foreclosure-Filings.pdf> [hereinafter PENNSYLVANIA]; Bernanke, Subprime Market, *supra* note 24, at 3 (“[T]he practice of selling mortgages to investors may have contributed to the weakening of underwriting standards.”).

39. See Engel & McCoy, *supra* note 35, at 2080–81 (arguing that disclosure laws do not effectively address predatory lending problems with subprime borrowers); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2255–63 (2007) (describing the inadequacy of current consumer protection laws in providing recourse against lending abuses with securitized financing).

40. See MARK DUDA & WILLIAM C. APGAR, NEIGHBORWORKS AM., MORTGAGE FORECLOSURES IN ATLANTA: PATTERNS AND POLICY ISSUES 1, 7 (2005), <http://www.nw.org/Network/neighborworksProgs/foreclosuresolutionsOLD/documents/foreclosure1205.pdf> (finding high foreclosure areas have approximately four times the level of nonprime loans); PENNSYLVANIA, *supra* note 38, at 27–32 (“[I]t is the subprime foreclosure rate that is driving rising foreclosure filings [in Pennsylvania].”); ELLEN SCHLOEMER ET

more than half of all foreclosures initiated in the last quarter of 2006.<sup>41</sup> A study by the Center for Responsible Lending estimates that more than 15% of all subprime, first-lien, and owner-occupied mortgage loans made between 1998 and 2006 will end in foreclosure.<sup>42</sup>

Specific loan terms that are far more prevalent in the subprime lending market are particularly correlated with higher foreclosure rates.<sup>43</sup> Failure to verify a borrower's income, loans at very high loan-to-value ratios (i.e., little or no equity), and interest only or negative amortizing loans all indicate a much higher probability of foreclosure.<sup>44</sup> Subprime loans made recently are significantly more likely to enter foreclosure because the risk profile of subprime loans began to worsen as lending volume was skyrocketing in the last few years.<sup>45</sup> By 2006, almost 80% of subprime loans were adjustable rate,<sup>46</sup> and about half of all subprime loans were based on no documentation or limited documentation.<sup>47</sup> Federal financial regulators have recently

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AL., CTR. FOR RESPONSIBLE LENDING, *LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS* 5 (2006), <http://www.responsiblelending.org/pdfs/CRL-foreclosure-rprt-1-8.pdf>; Engel & McCoy, *supra* 35, at 2042; Anne Balcer Norton, *Reaching the Glass Usury Ceiling: Why State Ceilings and Federal Preemption Force Low-Income Borrowers into Subprime Mortgage Loans*, 35 U. BALT. L. REV. 215, 221 (2005) (describing the continuing growth in foreclosures caused by the increase in subprime lending and the consequences); Pamela Prah, *Ohio Tries to Fend Off Foreclosures on Home Loans*, STATELINE.ORG, Apr. 23, 2007, <http://www.stateline.org/live/details/story?contentId=201186>.

41. Bernanke, *Subprime Market*, *supra* note 24.

42. SCHLOEMER ET AL., *supra* note 40, at 15–16 (citing two recent studies with results reflecting the relationship between the rate of foreclosure among subprime borrowers); *see also* Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* 1 (Fed. Reserve Bank of Boston, Working Paper No. 07–15, 2008), *available at* <http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf> (concluding that almost 20% of homeowners who used a subprime mortgage to obtain a home eventually will enter foreclosure, which is six times the rate for prime mortgages). *But see* MORTGAGE BORROWING, *supra* note 26, at 9–28 (arguing that foreclosure rates are not rising as rapidly as suggested by the CRL study, but noting that subprime loans enter foreclosure at a rate four times or more higher than the rate for prime loans).

43. SCHLOEMER ET AL., *supra* note 40, at 5.

44. *Id.*

45. *Id.* at 15–16 (estimating that over 19% of subprime loans made in 2005 or 2006 will enter foreclosure); IVY L. ZELMAN ET AL., CREDIT SUISSE, *MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE* 46 (2007), <http://www.recharts.com/reports/CSHB031207/CSHB031207.pdf>.

46. Sandra L. Thompson, Dir., Div. of Supervision and Consumer Prot., Fed. Deposit Ins. Corp., *Mortgage Market Turmoil: Causes and Consequences*, Statement Before Committee on Banking, Housing and Urban Affairs, U.S. Senate (Mar. 22, 2007) (transcript *available at* <http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmar22071.html>) (“[N]early 80% of securitized subprime loans were ARMs by early 2006.”).

47. ZELMAN ET AL., *supra* note 45, at 4 (“2006 subprime purchase originations

acknowledged the high risk factors and poor underwriting quality of many subprime loans.<sup>48</sup> A report from a major investment banking firm discussing weakening underwriting standards in the subprime mortgage lending industry quoted a private builder as reporting that “anybody with a pulse that was interested in buying a home was able to get financing” during 2006.<sup>49</sup>

The current foreclosure rise is unlikely to make a single pass and quickly recede back to historic levels.<sup>50</sup> The foreclosure problem in 2006 and 2007 does not account for a bulge of subprime adjustable rate loans that are “re-setting” to a higher interest rate through mid-2008.<sup>51</sup> Furthermore, the explosion in subprime lending starting in 2004 was accompanied by an equally dramatic increase in risky “nontraditional” mortgage products in the prime or near-prime mortgage loan market.<sup>52</sup> This segment of the market grew from about 2% of new mortgage originations in 2003 to about 18% for 2006.<sup>53</sup> In late July 2007, the nation’s largest mortgage lender announced a significant increase in loan defaults in both subprime and prime loans, with subprime default rates increasing from 13.4% to over 20% from

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posted an alarming 94% combined loan to value ratio.”).

48. See Bernanke, *Housing Market*, *supra* note 24 (stating that some of the increase in subprime delinquency is likely the result of looser underwriting standards); Bernanke, *Subprime Markets*, *supra* note 24; John C. Dugan, Comptroller of the Currency, Remarks Before the National Foundation for Credit Counseling Spring Meeting 1–2 (Apr. 24, 2007) (transcript available at <http://www.occ.treas.gov/ftp/release/2007-44a.pdf>) (“[W]e now know that the increase in subprime lending also reflects the fact that some lenders have been making loans that borrowers have no realistic prospect of repaying.”).

49. ZELMAN ET AL., *supra* note 45, at 24, 50 (noting a major issue in the subprime industry is “inflated appraisal values” resulting from “lax appraisal methods”); see also THOMAS BIER & IVAN MARIC, ARGENT MORTGAGE COMPANY LENDING AND FORECLOSURE ACTIVITY CUYAHOGA COUNTY, OHIO (2007) (linking subprime loan originations that result in foreclosure with unrealistically high property values) (on file with the Houston Law Review); Bernanke, *Housing Market*, *supra* note 24; Bernanke, *Subprime Market*, *supra* note 24 (stating that some of the increase in subprime delinquency is likely the result of looser underwriting standards).

50. See generally Karen Weaver, Katie Reeves & Art Frank, *The Subprime Mortgage Crisis and Potential Government Action*, Sept. 7, 2007 (describing the long term problems in the subprime market).

51. See ZELMAN ET AL., *supra* note 45, at 46–47; Weaver et al., *supra* note 50, at 3.

52. See ZELMAN ET AL., *supra* note 45, at 29–38.

53. Thompson, *supra* note 46, at 2–4; Vikas Bajaj, *Defaults Rise in Next Level of Mortgages*, N.Y. TIMES, Apr. 10, 2007, at C1. This part of the market is known as “Alt-A” loans, which includes lending to borrowers with slightly impaired credit and borrowers with prime credit but who obtain more risky forms of adjustable rate loans, such as an “option ARM” that allows the borrower the choice of paying less than the amount needed to amortize the loan. Together, subprime and Alt-A lending at these substantial levels represents an unprecedented increase in the risk profile of residential mortgage lending. See ZELMAN ET AL., *supra* note 45, at 1 (pointing out that together subprime and Alt-A mortgage lending accounted for about 40% of all new mortgage originations in 2006).

the same period in 2006, and defaults on home equity loans to borrowers with “good credit” more than doubling from 2.2% to 5.4% for the same period in 2006.<sup>54</sup> Financial markets responded by plummeting worldwide.<sup>55</sup>

### B. Impact of Rising Foreclosures on Communities

Foreclosure affects people with no direct relation to the mortgage transaction, including neighboring homeowners, renters, and municipalities.<sup>56</sup> This Subpart examines the effect of increased foreclosures on communities.

1. *Concentrated Subprime Mortgage Foreclosures Are Causing Blight.* Subprime lending has been geographically concentrated, and thus the current wave of foreclosures has been geographically concentrated.<sup>57</sup> Studies repeatedly show that foreclosure caused by subprime lending is clustered in poorer and minority communities.<sup>58</sup> This result has been observed in Philadelphia, Pennsylvania,<sup>59</sup> Atlanta, Georgia;<sup>60</sup> Chicago, Illinois;<sup>61</sup> Baltimore, Maryland;<sup>62</sup> and Minneapolis–Saint Paul,

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54. Vikas Bajaj, *Top Lender Sees Mortgage Woes for “Good” Risks*, N.Y. TIMES, July 25, 2007, at A1.

55. Floyd Norris & Vikas Rajaj, *Global Stock Markets Tumble Amid Deepening Credit Fears*, N.Y. TIMES, July 27, 2007, at A1.

56. WILLIAM C. APGAR & MARK DUDA, HOMEOWNERSHIP PRESERVATION FOUNDATION, COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY’S MORTGAGE FORECLOSURE BOOM 4–7 (2005), <http://nw.org/network/neighborworksprogs/foreclosuresolutionsOLD/documents/Apgar-DudaStudyFinal.pdf> (identifying actors outside the mortgage foreclosure and how they are impacted by the process).

57. PENNSYLVANIA, *supra* note 38, at 37. (“[T]he pattern of differences across counties is fairly consistent—areas with more highly clustered foreclosures tend to be areas with lower than average housing values, lower than average family incomes, higher than average percentages Black or African American and higher than average percentages Hispanic.” (emphasis omitted)).

58. *Id.*

59. *Id.*

60. See DEBBIE GRUENSTEIN & CHRISTOPHER E. HERBERT, THE NEIGHBORHOOD REINVESTMENT CORP., ANALYZING TRENDS IN SUBPRIME ORIGINATIONS AND FORECLOSURES: A CASE STUDY OF THE ATLANTA METRO AREA, at ii, 3 (2000), *available at* <http://www.abtassociates.com/reports/20006470781991.pdf> (analyzing HDMA data which shows that “[i]n very low-income neighborhoods, subprime lenders accounted for 37 percent of all originations in 1997—3 times the subprime market share in the Atlanta area overall”); Bajaj, *supra* note 19.

61. See DAN IMMERGLUCK & GEOFF SMITH, WOODSTOCK INST., RISKY BUSINESS—AN ECONOMETRIC ANALYSIS OF THE RELATIONSHIP BETWEEN SUBPRIME LENDING AND NEIGHBORHOOD FORECLOSURES 12–23 (2004), *available at* <http://www.woodstockinst.org/document/riskybusiness.pdf>.

62. See THE REINVESTMENT FUND FOR THE GOLDSEKER FOUND., MORTGAGE FORECLOSURE FILINGS IN BALTIMORE, MARYLAND 19 (2006), *available at* <http://www.nw.org/Network/neighborworksProgs/foreclosuresolutionsOLD/documents/mar>

Minnesota.<sup>63</sup> The concentration of subprime foreclosures in certain neighborhoods magnifies the deleterious impact of foreclosures on the community.<sup>64</sup>

The value of housing decreases in direct correlation to proximity of foreclosed properties.<sup>65</sup> A study in Chicago established a decrease in home values of 1.14% for homes within one-eighth of a mile from a foreclosure and a decrease of 0.325% for homes within one-fourth of a mile of a foreclosure.<sup>66</sup> The loss of housing value associated with foreclosures worsens when considering only low and moderate income tracts where foreclosures are concentrated.<sup>67</sup>

Foreclosure leads to a higher number of vacant and abandoned properties.<sup>68</sup> Vacant properties degrade the quality of life for neighbors; they are a “curse” on the livability of a

ylandForeclosuresIn2006.pdf [hereinafter BALTIMORE].

63. See INST. ON RACE & POVERTY, COMMUNITIES IN CRISIS: RACE AND MORTGAGE LENDING IN THE TWIN CITIES 2–3 (Aug. 6, 2008) (draft report on file with the Houston Law Review); MICHAEL GROVER ET AL., TARGETING FORECLOSURE INTERVENTIONS: AN ANALYSIS OF NEIGHBORHOOD CHARACTERISTICS ASSOCIATED WITH HIGH FORECLOSURE RATES IN TWO MINNESOTA COUNTIES 3, 4 (2007), available at [http://www.chicagofed.org/cedric/2007\\_res\\_con\\_papers/car\\_55\\_grover\\_targeting\\_foreclosure\\_interventions\\_revised\\_for\\_the\\_conf\\_1\\_12\\_2007.pdf](http://www.chicagofed.org/cedric/2007_res_con_papers/car_55_grover_targeting_foreclosure_interventions_revised_for_the_conf_1_12_2007.pdf); Jeff Crump, *Subprime Lending in Hennepin and Ramsey Counties: An Empirical Analysis*, 35 CURA REP., Spring 2005, at 18, available at <http://www.cura.umn.edu/reporter/05-Spr/Crump.pdf>.

64. Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355, 357–60 (2006).

65. See CTR. FOR RESPONSIBLE LENDING, SUBPRIME SPILLOVER 1 (2007), available at <http://www.responsiblelending.org/pdfs/subprime-spillover.pdf> (estimating that 40.6 million homeowners not in foreclosure will lose property value as a result of foreclosures of subprime mortgages); DAN IMMERGLUCK & GEOFF SMITH, WOODSTOCK INST., THERE GOES THE NEIGHBORHOOD: THE EFFECT OF SINGLE-FAMILY MORTGAGE FORECLOSURES ON PROPERTY VALUES 8–9 (2005), available at <http://www.woodstockinst.org/publications/download/there-goes-the-neighborhood%3a-the-effect-of-single%11family-mortgage-foreclosures-on-property-values/>.

66. See IMMERGLUCK & SMITH, *supra* note 65, at 8–9 (estimating that the average Chicago home would lose \$1,870 when the foreclosure was within one-eighth of a mile); see also Robert A. Simons, Roberto G. Quercia & Ivan Maric, *The Value Impact of New Residential Construction and Neighborhood Disinvestment on Residential Sales Price*, 15 J. REAL EST. RES. 147, 158 (1998) (stating that the value of a home falls \$788 within two blocks of tax delinquent homes).

67. See, e.g., IMMERGLUCK & SMITH, *supra* note 65, at 9 (noting that homes within one-eighth of a mile of foreclosure lose 1.8% of their value for lower-income census tracts).

68. See Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 530 (2005) (“A relatively large number of foreclosures in a low-income neighborhood may lead to abandonments.”); Edward M. Gramlich, Governor, Fed. Reserve Bd., Remarks at the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004) (transcript available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>) (discussing the link between subprime lending and foreclosure rates and stating that “[t]here is . . . evidence of serious neighborhood blight if foreclosure rates, and abandoned properties, proliferate in a given city area”).

community.<sup>69</sup> A study of vacancies in Austin, Texas, found that crime rates on blocks with vacant properties were about twice as high as blocks with similar demographics and no vacant buildings.<sup>70</sup> Vacant properties result in arson and health problems resulting from “trash, illegal dumping, and rodent infestations.”<sup>71</sup> Home values also sink substantially in direct proportion to the distance from a vacant home.<sup>72</sup> Vacant properties can increase the cost of home insurance.<sup>73</sup>

Foreclosures also have substantial negative consequences for municipal governments.<sup>74</sup>

Foreclosures and vacant properties simultaneously increase city costs while decreasing revenue.<sup>75</sup> Municipal costs may include increased policing and fire response, demolition, inspection, and administrative burdens.<sup>76</sup> A study of municipal expense in dealing with foreclosed vacant properties in Chicago estimated that the net municipal cost of dealing with each property range from \$430 to \$34,199 based on five typical scenarios.<sup>77</sup> At the same time that municipalities confront these costs, declining home values as a result of vacant properties erode the tax base.<sup>78</sup> The concentration of subprime lending in certain neighborhoods has led to a concentration of vacant properties that is causing neighborhood deterioration and overwhelming the ability of municipal governments to manage the problem.<sup>79</sup>

69. See NAT'L VACANT PROPS. CAMPAIGN, VACANT PROPERTIES: THE TRUE COSTS TO COMMUNITIES 1 (2005), available at [http://www.vacantproperties.org/latestreports/True%20Costs\\_Aug05.pdf](http://www.vacantproperties.org/latestreports/True%20Costs_Aug05.pdf) [hereinafter VACANT PROPERTY].

70. See William Spelman, *Abandoned Buildings: Magnets for Crime?*, 21 J. CRIM. JUST. 481, 484–85, 489–90 (1993); cf. VACANT PROPERTY, *supra* note 69, at 3 (citing a study of Richmond, Virginia, in which vacant buildings were the highest correlated to crime of all factors studied).

71. VACANT PROPERTY, *supra* note 69, at 4–5 (citing a report from the U.S. Fire Administration reporting over 12,000 fires in vacant properties each year).

72. *Id.* at 9.

73. *Id.* at 11.

74. See generally Engel, *supra* note 64, at 357–60 (describing the negative impacts of foreclosure on providers of municipal services).

75. *Id.* at 358–59.

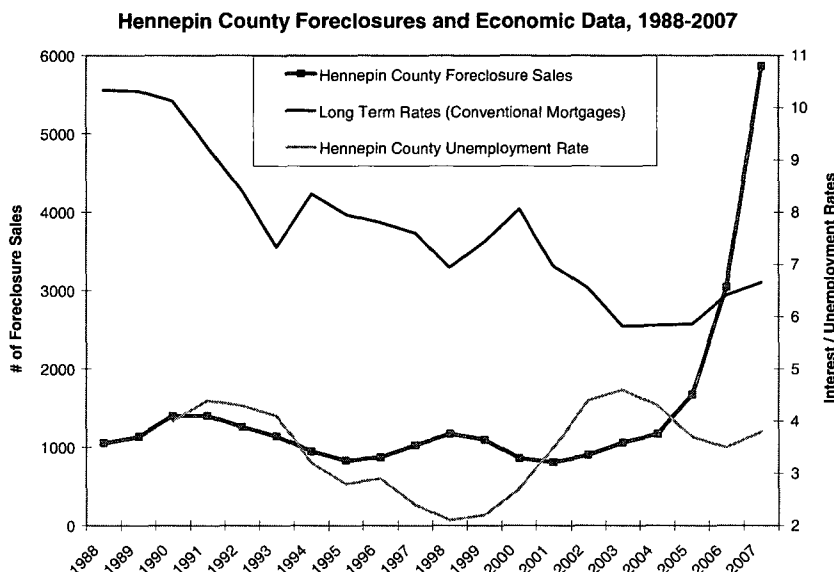
76. APGAR & DUDA, *supra* note 56, at 6 (“For municipalities, foreclosures trigger significant direct expenditures for increased policing and fire suppression, demolition contracts, building inspections, legal fees, and expenses associated with managing the foreclosure process (e.g., recordkeeping/updating).”).

77. WILLIAM C. APGAR, MARK DUDA & ROCHELLE NAWROCKI GOREY, HOMEOWNERSHIP PRESERVATION FOUND., THE MUNICIPAL COST OF FORECLOSURES: A CHICAGO CASE STUDY 23 (2005), available at <http://www.nw.org/network/neighborworksProgs/foreclosuresolutions/documents/2005Apgar-DudaStudy-FullVersion.pdf>.

78. See APGAR & DUDA, *supra* note 56, at 6; VACANT PROPERTY, *supra* note 69, at 9.

79. See, e.g., *Municipalities Struggle with Foreclosed Houses*, CASCADE, Fall 2007,

2. *Metropolitan Example: Minneapolis, Minnesota.* Hennepin County, Minnesota, which includes Minneapolis, is a relatively prosperous and stable urban area. It also has neighborhoods that are being devastated by foreclosures. The following chart shows foreclosure sales<sup>80</sup> and related economic data<sup>81</sup> from 1988 through 2007:



at 15, available at [http://www.philadelphiafed.org/ccapubs/cascade/66/cascade\\_no-66.pdf](http://www.philadelphiafed.org/ccapubs/cascade/66/cascade_no-66.pdf) (describing the problem of concentrated foreclosures in Cleveland and its inner-ring suburbs).

80. Foreclosure Sale Data is from the records of the Hennepin County Sheriff's Office (on file with the Houston Law Review). Foreclosure sales are for year-end 2007. In Minnesota, the foreclosure sale typically is near the middle of the foreclosure process because the borrower usually has a six month redemption period during which the borrower can possess the property. See MORTGAGE DIRECTORY, *supra* note 19, at 1-159-66 (describing Minnesota foreclosure procedures).

81. Unemployment data is from the Minnesota Department of Employment and Economic Development, <http://www.deed.state.mn.us/lmi/tools/laus/detail.asp?geog=2704000053&adjust=0> (last visited Sept. 5, 2008). Unemployment rate is current as of May 2007. Conventional mortgage interest rates data is from the Federal Reserve Board, <http://www.federalreserve.gov/releases/h15/data.htm> (last visited Sept. 5, 2008). The interest rate data is based on June 2007 monthly rates. Similar increases in foreclosure rates occurred throughout Minnesota starting in 2005. GREATER MINN. HOUS. FUND & HOUSINGLINK, FORECLOSURES IN GREATER MINNESOTA: A REPORT BASED ON COUNTY SHERIFF'S SALES DATA 6-7 (2007), [http://www.housinglink.org/adobe/reports/GreaterMN\\_Foreclosure\\_Oct2007\\_Supplement.pdf](http://www.housinglink.org/adobe/reports/GreaterMN_Foreclosure_Oct2007_Supplement.pdf) (finding a foreclosure sales increase of 48% from 2005 to 2006 in Minnesota outside of the Twin Cities metropolitan area and projecting a 84% increase from 2006 to 2007).

Hennepin County had a steady number of mortgage foreclosure sales per year from 1988 through 2004, followed by an extraordinary, more than five-fold increase in foreclosure sales from 2005 through 2007.<sup>82</sup>

Hennepin County provides a good example of the degree of racial and low income concentration in foreclosures. The foreclosure rate was 2 per 1,000 loans in census tracks that were 80% or more white, but 26 per 1,000 loans in census tracks 80% or more non-white, with a straight line increase in foreclosures as non-white concentration increases in the census track.<sup>83</sup> A similar strong correlation exists between low income census tracks and foreclosure rates.<sup>84</sup>

### III. BORROWERS, LENDERS, AND MORTGAGE FORECLOSURE LAW

The rights of parties to a mortgage developed over centuries of English law as a means to fairly balance the interest of borrowers and lenders when land ownership is used as security for a loan.<sup>85</sup> English courts of equity developed the still extant concept of the equitable right of redemption, which provides that when a borrower who gave a mortgage defaults on the payment, he retains the right to pay off the debt for a fixed period after the default.<sup>86</sup> English courts then created the right of the mortgage lender to “foreclose” this equitable right to redeem.<sup>87</sup> Ultimately, lenders and the courts evolved the generally accepted mortgage foreclosure procedure that has been mostly codified today, which provides for sale of a property by the lender after compliance

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82. Analysis was based on data retrieved from Hennepin County Sheriff's Office website, <http://www4.co.hennepin.mn.us/webforeclosure/> (last visited Sept. 5, 2008). In the period from 1988 through 2004, the number of foreclosure sales in Hennepin County was never more than 32% higher or 24% lower than the average of 1,066 foreclosure sales per year. *Id.*

83. *Id.*; GROVER ET AL., *supra* note 63, at 15, 35; *see also* INST. ON RACE & POVERTY, *supra* note 63, at 2–3; Crump, *supra* note 63, at 17–18 (demonstrating a statistical link between race and foreclosure rates).

84. GROVER ET AL., *supra* note 63, at 35.

85. Ann M. Burkhardt, *Lenders and Land*, 64 MO. L. REV. 249 *passim* (1999) (providing a detailed history of the relationship between a borrower and lender in a land purchase). This Article uses the more easily distinguishable and simple terms “borrower” and “lender,” rather than “mortgagor” and “mortgagee.” In most cases, the lender is a mortgagee who has been assigned ownership of the mortgage loan from the originating lender or another assignee.

86. *Id.* at 264.

87. *Id.* at 265–66.



with procedural requirements for terminating the borrower's interests.<sup>88</sup>

Foreclosure occurs under federal law only for certain mortgages held by the United States Department of Housing and Urban Development.<sup>89</sup> Bankruptcy also provides controlling federal law for those who seek bankruptcy protection during the proceeding, especially with a Chapter 13 filing.<sup>90</sup> State law nonetheless controls the overwhelming majority of foreclosures.<sup>91</sup>

Many transactions governed primarily by state law either strive for uniformity or are generally recognizable from state to state.<sup>92</sup> Contract disputes, for example, are settled under widely-held common law tenets or the Uniform Commercial Code.<sup>93</sup> State foreclosure laws do not adhere to this pattern.<sup>94</sup> Foreclosure laws vary dramatically in both substantive rights of the parties and in the procedures used to complete the process.<sup>95</sup>

Attempts to enact uniform state foreclosure laws have been an abysmal failure.<sup>96</sup>

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88. *Id.* at 265–67.

89. Multifamily Mortgage Foreclosure Act, 12 U.S.C. § 3701 (2006); Single Family Mortgage Foreclosure Act, 12 U.S.C. § 3751 (2006).

90. See Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk*, 2007 U. ILL. L. REV. 323, 327–28 (2007). Legislation currently pending in the United States Congress would make it easier for homeowners to file for Chapter 13 bankruptcy protection by deleting the current prohibition on loan modifications for residential mortgage loans. See H.R. Res. 3609, 110th Cong. (2007).

91. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1415 (2004) (describing federal foreclosure laws, but noting that mortgage law remains largely the province of the states); Debra Pogrud Stark, *Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws*, 51 OKLA. L. REV. 229, 238–42 (1998) (describing various federal laws governing foreclosure).

92. See generally Fred H. Miller & Albert J. Rosenthal, *Uniform State Laws: A Discussion Focused on Revision of the Uniform Commercial Code*, 22 OKLA. CITY U. L. REV. 257, 262–64 (discussing the process of creating uniformity in state law).

93. *Id.* at 320; see also Robert F. Blomquist, *Ten Vital Virtues for American Public Lawyers*, 39 IND. L. REV. 493, 498 (2006) (indicating the interaction of the common law and Uniform Commercial Code in contract law).

94. See, e.g., Grant S. Nelson, *A Commerce Clause Standard for the New Millennium: "Yes" to Broad Congressional Control over Commercial Transactions; "No" to Federal Legislation on Social and Cultural Issues*, 55 ARK. L. REV. 1213, 1244–45 (2003) (detailing the diverse and nonuniform state approaches to foreclosure law).

95. See Nelson & Whitman, *supra* note 91, at 1401 ("Mortgage law varies enormously from state to state and represents an often perplexing amalgam of English legal history, common law, and legislation."). See generally MORTGAGE DIRECTORY, *supra* note 19 (cataloging the varying requirements of each state foreclosure law); RAO ET AL., *supra* note 21, at § 1.3.1.2, app. C (noting the variability of state foreclosure laws and cataloging the varying requirements of each state law).

96. Nelson & Whitman, *supra* note 91, at 1408–09. There have been numerous attempts at uniform state law promulgation through the National Conference of Commissioners on Uniform State Laws, including the Uniform Real Estate Mortgage Act (1927); the Model Power

Subpart A of this section describes the basic elements that can be found in various state foreclosure laws. Subpart B looks at how the existence and arrangement of different elements in various state foreclosure laws creates vastly different incentives for the parties in a foreclosure proceeding. Subpart C examines the incentives and options for borrowers and for lenders in dealing with mortgage default and foreclosure.

### A. *Elements of State Foreclosure Laws*

The common denominator in state foreclosure laws is some form of notice to some interested party or parties.<sup>97</sup> Not much else can be said to unite the bewildering diversity in both substantive rights of the parties and the procedures required to complete the foreclosure.<sup>98</sup>

1. *Judicial Versus Nonjudicial Procedures.* The primary procedural difference between state foreclosure laws is whether the jurisdiction requires judicial action.<sup>99</sup> In states with “judicial foreclosure,” the process usually starts with a summons and complaint and requires a court order prior to the sale of the mortgaged property.<sup>100</sup> Judicial foreclosure procedures generally are more costly for the lender and take much longer to complete.<sup>101</sup> While nominally a court-supervised process, borrowers routinely fail to appear and the proceedings typically are resolved by default.<sup>102</sup>

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of Sale Foreclosure Act (1940); the Uniform Land Transactions Act (1975); and the Uniform Land Security Interest Act (1985). No state adopted any of these proposed uniform laws. *Id.* at 1407–09, 1408 n.49. In 2002, the Conference of Commissioners on Uniform State Laws tried with the Uniform Nonjudicial Foreclosure Act. *See* UNIF. NONJUDICIAL FORECLOSURE ACT (2002) [hereinafter UNFA] (The act was printed in the Uniform Laws Annotated at 14 U.L.A. 131 (2005)). Efforts to enact federal foreclosure laws also have been unsuccessful. Janet A. Flaccus, *Pre-Petition and Post-Petition Mortgage Foreclosures and Tax Sales and the Faulty Reasoning of the Supreme Court*, 51 ARK. L. REV. 25, 46 (1998) (noting two failed attempts by the Senate to add protections for mortgage foreclosure buyers).

97. Basil H. Mattingly, *The Shift from Power to Process: A Functional Approach to Foreclosure Law*, 80 MARQ. L. REV. 77, 93–94 (1996) (describing the foreclosure process and how it may vary from state to state).

98. *Id.*; *see also* Nelson, *supra* note 94, at 1243–45.

99. Mattingly, *supra* note 97, at 92. (“[F]oreclosure models may be divided into two broad categories: judicial foreclosures and nonjudicial foreclosures.”).

100. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 7.11 (4th ed. 2001); *see, e.g.*, MORTGAGE DIRECTORY, *supra* note 19, at 208–10 (describing initiation of a judicial foreclosure action in New York).

101. *See* Nelson & Whitman, *supra* note 91, at 1403 (reviewing the basic judicial foreclosure process and highlighting the inherent delays and costs); *see also* Stark, *supra* note 91, at 232 (contrasting judicial and nonjudicial foreclosures and emphasizing the time and cost advantages in nonjudicial foreclosures).

102. *See* Stark, *supra* note 91, at 244 (finding that in only 1% of the 1993 cases and in

States permitting nonjudicial foreclosure are said to use a "power of sale" process whereby the lender, or a trustee, is allowed to conduct a foreclosure sale without court involvement after sending the required notices.<sup>103</sup> About thirty states permit power of sale foreclosure.<sup>104</sup> States allowing power of sale foreclosure also have judicial procedures available to the lender, although they are rarely used in most states.<sup>105</sup> Two New England states primarily employ different forms of "strict foreclosure" that can allow the foreclosing lender to avoid the sale procedure and just take title to the property.<sup>106</sup>

2. *Notice Requirements.* Notice in states with judicial foreclosure follows the form of notice in a civil action.<sup>107</sup> States with power of sale foreclosure generally use either a one-notice system or a two-notice system.<sup>108</sup> Both systems require a notice of foreclosure, but the two-notice system requires a prior notice of default, typically accompanied by a right to reinstate the loan by paying the arrearage.<sup>109</sup> The name and contents of the notices, the timing requirements, the methods of service, and the people who must be served vary widely among the states.<sup>110</sup> Alabama, for example, requires only one "Notice of Sale" that must be published once a week for three consecutive weeks.<sup>111</sup> California

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none of the 1994 cases in the Empirical Study did the borrower raise a defense to the foreclosure action in the judicial proceeding); see also Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1131-32 (1996) (detailing propensity of consumers sued by their creditors to default, although homeowners would be more likely to appear at a hearing than sue for an injunction).

103. NELSON & WHITMAN, *supra* note 100, at § 7.19. A prerequisite to nonjudicial foreclosure is that the mortgage note allows for the lender to liquidate the real property through a sale process. Brandon Bennet, *Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns*, 77 TEX. L. REV. 1443, 1466 (1999) (asserting that power of sale provisions are required for nonjudicial foreclosures). Standard loan documents in states permitting a power of sale all contain this type of authority. See, e.g., MORTGAGE DIRECTORY, *supra* note 19, *passim* (describing the prevalence of nonjudicial foreclosure in certain states and the power of sale clauses regularly used in financing documents); RAO ET AL., *supra* note 21, at § 4.2.3 (explaining that twenty-six states use nonjudicial foreclosure based on power of sale clauses in mortgages and deeds of trust).

104. NELSON & WHITMAN, *supra* note 100, at § 7.19.

105. See MORTGAGE DIRECTORY, *supra* note 19, *passim* (describing nonjudicial foreclosure processes in certain states and noting that judicial proceedings are only used if there is a defect in the financing documents or if there is some other unusual circumstance).

106. *Id.* at § 7.9.

107. Nelson & Whitman, *supra* note 91, at 1403.

108. UNFA, *supra* note 96, at 4.

109. *Id.*

110. RAO ET AL., *supra* note 21, at app. C (describing the notice requirements in each state foreclosure law).

111. ALA. CODE § 35-10-13 (LexisNexis 1996); MORTGAGE DIRECTORY, *supra* note 19, at 2.

law provides for a two-notice system.<sup>112</sup> The Notice of Default must contain specified information, including the amount necessary to cure the default, must be recorded, and must be served by first class and certified mail.<sup>113</sup> The Notice of Sale must be publicly posted, published, and served at least twenty days before the foreclosure sale.<sup>114</sup>

3. *Foreclosure Sale Procedures.* The typical foreclosure sale is not a scene from movie lore with an excited mob on the courthouse steps or at the foreclosed property. Some foreclosure sales have multiple potential bidders.<sup>115</sup> In other situations, the sale of the property occurs at the local sheriff's office with only the lender, perhaps the borrower, and the selling official present.<sup>116</sup> While the lender can make a credit bid, offering up to the amount it is owed, other purchasers typically are required to provide cash.<sup>117</sup> The highest "bidder" at a foreclosure sale often is the lender.<sup>118</sup> For a variety of reasons, the foreclosure sale rarely brings a market price.<sup>119</sup> The foreclosure sale itself does not differ simply because the state uses judicial foreclosure as opposed to power of sale procedures, although the validity of the sale may be more questionable in a power of sale process.<sup>120</sup>

4. *Borrower Redemption and Reinstatement Rights.* Borrowers also have important substantive rights provided by

112. CAL. CIV. CODE § 2924(a) (West 1993 & Supp. 2008).

113. CAL. CIV. CODE § 2924(a)(1) (West 1993 & Supp. 2008); MORTGAGE DIRECTORY, *supra* note 19, at 34.

114. CAL. CIV. CODE §§ 2924(a)(3), 2924(f) (West 1993 & Supp. 2008); MORTGAGE DIRECTORY, *supra* note 19, at 34.

115. See, e.g., Bajaj, *supra* note 19 (describing the strong interest at one foreclosure sale in Atlanta, where more than 200 people came out to the auction).

116. Evan H. Krinick, *Deposits by Bidders at a Sheriff's Sale*, 117 BANKING L.J. 446, 446-50 (2000) (detailing the process of the sheriff's sale).

117. *Id.* at 446-47.

118. Stark, *supra* note 18, at 663 ("In most cases, the only people present at the foreclosure sale are the lender, the borrower, and the party conducting the foreclosure sale. Third parties successfully bid in only 11.2% of the 1993 judicial sales cases and only 9.6% of the 1994 judicial sales cases."); Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure: An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 865, 875 (1985) (finding that in Onondaga County, New York, "[i]n the sample of 118 foreclosure sales, the mortgagee bid successfully in 91 cases, or seventy-seven percent of the total, and third parties bought in 27 cases, or twenty-three percent of the total").

119. Nelson & Whitman, *supra* note 91, at 1420-23 (describing barriers to obtaining market price at foreclosure auction and concluding that, "In sum, it would be difficult to design a sale procedure less apt to result in market prices than the usual foreclosure auction.").

120. Mattingly, *supra* note 97, at 95 (inferring that borrowers more readily question nonjudicial sales).

foreclosure statutes in many states.<sup>121</sup> Under common law, foreclosure extinguishes the borrower's right of redemption in equity.<sup>122</sup> Statutory redemption rights extend the borrower's right to recover the property by paying off the full amount bid at the foreclosure sale plus additional costs.<sup>123</sup> In most states with a redemption period, the borrower can maintain possession of the property during the redemption period.<sup>124</sup> Redemption periods vary from ten days to two years.<sup>125</sup>

Mortgage notes typically provide for acceleration of the full amount of the loan and unpaid interest within thirty days following the lender's notice to the borrower of default.<sup>126</sup> Standard loan documents include a reinstatement right up to a fixed number of days before the foreclosure sale or until entry of judgment.<sup>127</sup> Some state foreclosure laws also expressly provide the right to reinstate the loan by paying the arrearage on the loan plus some costs.<sup>128</sup> This statutory right of reinstatement extends up to the date of the foreclosure sale in some states, is extinguished a number of days prior to the foreclosure sale in other states, and runs from the notice of default or service of the complaint in yet other states.<sup>129</sup> Even in the absence of statutory or contractual rights, many lenders will voluntarily accept reinstatement prior to the foreclosure sale.<sup>130</sup>

5. *Antideficiency Protections.* As with any other loan, if the foreclosure sale price is less than the amount the borrower owes, the borrower can be liable for a deficiency judgment.<sup>131</sup> As with much of state foreclosure law, the scope and protection against a

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121. See generally Mattingly, *supra* note 97 *passim* (discussing the rights of the borrower and the power struggle between borrower and lender).

122. George M. Platt, *The Dracula Mortgage: Creature of the Omitted Junior Lienholder*, 67 OR. L. REV. 287, 293-95 (1988).

123. *Id.* at 294-96; Nelson & Whitman, *supra* note 91, at 1404.

124. NELSON & WHITMAN, *supra* note 100, at § 8.4.

125. MORTGAGE DIRECTORY, *supra* note 19, at 1-221, 1-272.

126. Nelson & Whitman, *supra* note 91, at 1464.

127. Mattingly, *supra* note 97, at 86 n.38.

128. Nelson & Whitman, *supra* note 91, at 1465.

129. See, e.g., MINN. STAT. ANN. § 580.30 (West 2000) (permitting right to reinstate up to date of sale); NEV. REV. STAT. ANN. § 107.080(2)(a) (LexisNexis 2007 & Supp. 2008) (granting right to reinstate for thirty-five days after notice of default recorded and served); WASH. REV. CODE ANN. § 61.24.090 (West 2004) (allowing borrower to reinstate until eleven days before foreclosure sale).

130. See STATE FORECLOSURE PREVENTION WORKING GROUP, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE: DATA REPORT NO. 1 12-13 (2008), available at [http://www.state.ia.us/government/ag/latest\\_news/releases/feb\\_2008/Foreclosure\\_Prevention.pdf](http://www.state.ia.us/government/ag/latest_news/releases/feb_2008/Foreclosure_Prevention.pdf) [hereinafter STATE FORECLOSURE GROUP].

131. NELSON & WHITMAN, *supra* note 100, at § 8.

deficiency judgment varies widely.<sup>132</sup> Some antideficiency statutes protect borrowers against any deficiency judgments, while other states limit the amount of any potential deficiency judgment to the fair market value of the property.<sup>133</sup> Several states prohibit deficiency judgments with a power of sale procedure but allow such an action in a judicial proceeding.<sup>134</sup> As a practical matter, lenders do not routinely seek or collect on deficiency judgments against foreclosed borrowers.<sup>135</sup>

### *B. Effect of Varying Foreclosure Laws*

The presence, sequencing, and specific terms of these elements in a state foreclosure law make for drastically different incentives for the parties to the process.<sup>136</sup> The varying financial and personal circumstance of borrowers adds another layer of complexity to the effect of a state law on how borrowers and lenders will act during foreclosure.<sup>137</sup> Consider an example of two different borrowers under two different foreclosure laws.

1. *Hypothetical Foreclosure Laws in States A and B.* State A has a foreclosure law with the following characteristics:

- Power of sale procedures are allowed with a three month notice period culminating in a sheriff's sale;
- A six month statutory redemption period for the borrower with the right of possession by the borrower, and then a one week period for each junior lien holder to exercise redemption rights and pay off all senior lien holders; and
- An antideficiency provision applicable to all borrowers if the power of sale process is used, but deficiency judgments are permitted if a judicial foreclosure process is selected by the foreclosing lender.

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132. *Id.* at § 8.3.

133. *Id.*; James B. Hughes, Jr., *Taking Personal Responsibility: A Different View of Mortgage Anti-Deficiency and Redemption Statutes*, 39 ARIZ. L. REV. 117, 124 (1997).

134. *See* NELSON & WHITMAN, *supra* note 100, at § 8.3.

135. *See* Wechsler, *supra* note 118, at 878 (noting only one deficiency judgment obtained among "the ninety-four studied cases in which the foreclosure sale left a deficiency amount . . . and in that case the judgment was not satisfied"); *see also* Stark, *supra* note 91, at 244 ("Lenders brought a deficiency action within one year after the foreclosure sale in approximately six to seven percent of the foreclosure sale cases.").

136. *See generally* Mattingly, *supra* note 97, at 101–03 (detailing various incentives and obstacles with respect to foreclosure laws).

137. *Id.* at 84–89 (hypothesizing about potential complications and frustrations based on the borrowers' situations).

The power of sale process in State A typically takes a minimum of nine months from default, including the six month redemption period. Although rarely used because of the expense, State A has an alternative judicial procedure that takes a minimum of fourteen months from default, including the six month redemption period after the foreclosure sale.

State B has a foreclosure law with the following characteristics:

- Power of sale procedures are allowed with a two month notice period culminating in a sheriff's sale;
- No statutory redemption period; and
- No antideficiency provision. The amount of the deficiency (if any) is equal to the amount owed on the debt minus the foreclosure sale price. Any surplus from the foreclosure sale is distributed to all the lien holders in priority order, with any remainder to the homeowner.

The power of sale process takes a minimum of three months from default in State B. The alternative judicial foreclosure procedure in State B typically takes a minimum of nine months from default, but otherwise the same lack of borrower protections apply.

2. *The Smiths.* The Smith family has owned a single family residence for nine years. The home is worth \$235,000, with selling expenses of about \$15,000. The Smiths' home is encumbered by a first lien mortgage loan of \$175,000. The Smiths also have a \$5,000 judgment against them from a prior credit card debt. The Smiths, therefore, have about \$40,000 in realizable equity in the property, with \$180,000 of encumbrances on a home worth a net of \$220,000 after selling costs.

The Smiths have three children and desperately want to stay in their current home. Based on their current credit score, income, and debts, the Smiths qualify for a refinancing loan of only \$125,000 at a high interest rate. Mr. Smith is recovering from an illness and unemployed. If he can find work in his field, it is much more likely the Smiths will be able to obtain a loan, either a refinancing loan or a home equity loan, sufficient to either reinstate their mortgage in foreclosure or redeem the property.

The lender foreclosing on the Smiths in State A very likely will use the quicker, less expensive power of sale procedure. The foreclosure sale, however, will almost surely consist of only the bid by the lender for the amount owed, \$175,000, because in a state with a six month redemption period, a party other than the

lender would have to make a cash bid at the sale knowing that the home has a substantial chance of being redeemed because the borrower has equity in the property. There is little chance for a third party to make money when he or she has to pay cash for the home; wait six months and hope that the Smiths do not redeem or sell the home; that the Smiths' judgment creditor doesn't redeem or sell the judgment to a specialist in foreclosure purchases who would redeem the property; that the property is not substantially damaged; and that no other judgment creditors or lien holders with the intent to redeem appear during the redemption period. Nor does the lender have an incentive to bid less than the amount owed to it because there is no prospect of a deficiency judgment due to antideficiency legislation.

Because their top priority is to stay in the home, the Smiths likely will pursue reinstatement or refinancing of the loan. After the foreclosure sale, the Smiths will face difficult decisions during the six month redemption period. The foreclosure sale will have resulted in no surplus because the lender will have bid the amount it was owed, so the end of the redemption period will mean the Smiths not only lose possession of the home, but also lose their equity in the property. The longer they wait to sell their home, the less time they will have to obtain the best price and liquidate the equity in their home. The Smiths will be making these pressing choices at a time of extraordinary stress from lack of employment and income, and very likely managing debt and debt collectors.

The actions of the lender probably will be no different in State B. The lender again will use the power of sale procedure. If the property goes to a foreclosure sale, the lender likely will bid the amount owed plus costs, as in State A. A higher bid could result in a surplus due to the Smiths; a lower bid will result in no gain because any deficiency judgment against the Smiths probably will be uncollectible and be dischargeable in bankruptcy.

State B has fewer protections for borrowers, leaving the Smiths with limited options. The likelihood of the Smiths retaining their home, their top priority, is substantially less in State B. Given the much shorter period between default and dispossession, the Smiths probably will need to immediately put the house on the market to have a chance of controlling the sale price and the amount of equity they will receive. If the Smiths are unable to sell their home before the date of the foreclosure sale, they will receive a portion of their equity only in the unlikely event that the foreclosure sale exceeds about 80% of the



fair market value, which is the amount they owe to the foreclosing lender and judgment credit.

3. *Investor Jones*. Investor Jones owns ten single family residential properties in an area that has suffered from declining property values. One of her properties is located at 100 Main Street and is in deteriorating condition.

The house at 100 Main is worth about \$175,000 and is encumbered by a mortgage loan of \$200,000. The unit currently provides Jones with \$1,500 per month in rental income. 100 Main recently became a cash drain when the adjustable rate mortgage rose by 1%. Jones stopped paying on the loan and let it go into foreclosure. Seven of her other properties also are unprofitable. Jones has little net worth and few assets other than the ten rental buildings, and seven of the ten properties are mortgaged to at least the full amount of their fair market value.

The lender faces a choice of which procedure to use in state A. The power of sale procedure is quicker by five months and less costly, but the judicial foreclosure process offers the possibility of a deficiency judgment. The lender will have to weigh the value of a relatively small deficiency judgment against a perhaps insolvent Jones against a more rapid acquisition of the property.

Jones will attempt to collect rent from the tenants in 100 Main while she is in possession of the property.<sup>138</sup> She will also make the least possible investment in the maintenance of the property while it is in foreclosure. In State A, Jones could be able to obtain \$21,000 or more in rental income (14 months @ \$1,500 per month) if the lender selects the judicial foreclosure procedure. Even with the power of sale process in State A, Jones can collect over \$13,500 (9 months @ \$1,500 per month) in rental income. Jones would have no mortgage loan payment and little expense from a property in which she is disinvesting. Jones could also consider selling the building if the lender chooses a judicial proceeding and Jones is concerned with minimizing a deficiency judgment.

In State B, the power of sale procedure, which includes the possibility of a deficiency judgment, is the preferred alternative for the lender. The foreclosure process will move much more rapidly toward a transfer of title and possession to the foreclosing

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138. While a foreclosing lender may have a legal right to rent proceeds during foreclosure, as a practical matter this income typically is realized by the borrower in default. See Julia Patterson Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions*, 59 FLA. L. REV. 487, 492-93 (2007); R. Wilson Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 71 MO. L. REV. 1, 5 (2006).

lender. Jones in State B will have to make a quick decision on whether to sell the house in an attempt to minimize a deficiency judgment.

The above scenarios are just examples of the limitless possibilities for different incentives and outcomes depending on the foreclosure law in the state and the circumstances facing the borrower and lender.

### C. Conduct of Lenders and Borrowers in Foreclosure

Foreclosure is the end-game of mortgage default.<sup>139</sup> Different types of borrowers and the foreclosing lender approach mortgage default and foreclosure from a variety of perspectives.<sup>140</sup>

1. *Lender Response to Mortgage Default.* Lenders typically lose substantial amounts of money on a foreclosure.<sup>141</sup> The amount of the loss per foreclosure can be \$50,000 or more.<sup>142</sup> Beginning in the 1990s, many lenders began to avoid the high cost of foreclosure by engaging in a “workout” whenever possible.<sup>143</sup> The options in a workout that preserve ownership for

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139. See generally Mattingly, *supra* note 97, at 93–94 (detailing the basic timeline of mortgage foreclosures).

140. See Nelson & Whitman, *supra* note 91, at 1467–68 (describing the competing interests of the foreclosing creditor, the borrowers, and junior lienors). Borrowers and foreclosing lenders are not the only interested parties to a foreclosure. *Id.* Other lien holders and judgment creditors also have an interest in the process. *Id.* The proposals made in this Article do not explicitly account for these parties, but nothing proposed here should impact existing law as to other lien holders so as to further disadvantage these parties relative to the other people with an interest in the property.

141. Richard M. Todd & Michael Grover, *Post-Purchase Counseling: An EMHI Strategy to Close Homeownership Gaps*, 4 COMMUNITY DIVIDEND (2005), available at <http://www.minneapolisfed.org/pubs/cd/05-4/counseling.cfm>.

142. *Id.*; Terrence M. Clauretie, *Mortgage Lending: The Risks of Foreclosure Laws*, ORER LETTER (Spring 1990), available at <http://www.business.uiuc.edu/orer/V4-2-2.pdf> (observing that foreclosure laws providing excessive protection to borrowers can cause lenders losses of up to 60–70% and that the average loss nationwide is 40%).

143. CHARLES A. CAPONE, JR., RESEARCH INTO MORTGAGE DEFAULT AND AFFORDABLE HOUSING: A PRIMER 14 (2002), available at [http://www.lisc.org/files/906\\_file\\_asset\\_upload\\_file755\\_793.pdf](http://www.lisc.org/files/906_file_asset_upload_file755_793.pdf); see also FORUM, *supra* note 25, at 2 (describing a typical servicing agreement as permitting loan modification or forbearance when it is “in the best interests of the securityholders or not materially adverse to the interests of the securityholders”). Loan workouts also are known as “loss mitigation” in the mortgage lending industry. *Id.* at 2–3. The growth of securitization in mortgage lending has complicated the workout process. See generally *id.* at 3–4 (listing numerous considerations for loss mitigation). The “lender” is an abstract notion with the securitized loan, as ownership rests on a complicated series of securitization agreements. See generally CAPONE, *supra*, at 5, 12 (explaining tranches and mortgage-backed securities). In the absence of an easily identifiable mortgagee decision-maker, the mortgage servicer typically makes all the decisions in negotiating an acceptable workout arrangement with the borrower. FORUM, *supra* note 25, at 3–4. The discretion of the servicer, however, is constrained by the terms of the securitization servicing agreement, which often are

the defaulting borrower include modifying the loan terms and an extended period for repayment of the arrearage.<sup>144</sup> Another possible result of a workout is the early termination of the borrower's interest in the property by a deed-in-lieu of foreclosure or a "short sale," which is an agreement to accept less than the amount owed on the loan following sale of the property.<sup>145</sup> The savings from avoiding foreclosure through a workout are so great for the lender that the workout can be justified based on a success rate for loan modification or forbearance of 40% or less.<sup>146</sup> Lenders typically will attempt to work out the loan and will wait 90 days before taking the first steps to initiate the foreclosure process.<sup>147</sup>

Foreclosure laws have an effect on whether a lender pursues foreclosure or a loan workout.<sup>148</sup> A study by Terrence Clauretje found that states with costlier and longer foreclosure processes had lower foreclosure rates.<sup>149</sup> This result makes sense. Lenders facing greater costs in foreclosure due to state law will be more likely to engage in nonforeclosure solutions to mortgage default.<sup>150</sup> If a mortgage lender could repossess a home as easily as an automobile could be repossessed on loan default, foreclosure rates would no doubt increase substantially.<sup>151</sup>

2. *Borrowers in Mortgage Default.* The primary reasons borrowers traditionally have defaulted on their mortgage are, in order of importance, job loss and reduced income, financial problems other than income loss, divorce, and illness.<sup>152</sup> Homeowners in default tend to be younger, employed, married,

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ambiguous as to the proper limits for loan modification or forbearance. *See generally id.* at 4 (discussing individual loan workout decisions). The American Securitization Forum, a trade organization for companies in the mortgage-backed securities market, has issued a guidance encouraging a liberal interpretation of the servicing agreements in favor of workout arrangements with first lien subprime loans. *See* STATE FORECLOSURE GROUP, *supra* note 130, at 12-13 (describing use of loan modifications by various servicers in current foreclosure crisis).

144. CAPONE, *supra* note 143, at 15.

145. *Id.*

146. *See* Brent W. Ambrose & Charles A. Capone, Jr., *Cost-Benefit Analysis of Single-Family Foreclosure Alternatives*, 13 J. REAL EST. FIN. ECON. 105, 114 tbl.4 (1996).

147. ZELMAN ET AL., *supra* note 45, at 42.

148. CAPONE, *supra* note 143, at 13-14.

149. Terrence M. Clauretje, *The Impact of Interstate Foreclosure Cost Differences and the Value of Mortgages on Default Rates*, 15 J. AM. REAL EST. & ECON. ASS'N 152, 162, 164 (1987).

150. *See id.* at 157 (opining on the importance of time and cost in choosing nonjudicial foreclosure).

151. *See id.* (noting the preference of lenders towards easy means of foreclosure).

152. Mona J. Gardner & Dixie L. Mills, *Evaluating the Likelihood of Default on Delinquent Loans*, 18 FIN. MGMT. 55, 57 (1989).

and more likely to live in their first home.<sup>153</sup> Not surprisingly, such borrowers experience more stress around finances, have a more difficult time prioritizing bills, and are more often late in paying financial obligations.<sup>154</sup> Homeowners in default also are less likely to be comfortable discussing finances and less likely to trust their lender.<sup>155</sup> They also are more likely to have paid more for their loan than would be expected based on their credit and financial profile; in other words, borrowers in foreclosure are more likely to have gotten an unfair or predatory loan.<sup>156</sup>

a. *Types of Borrowers in Default.* This Article will use the following terms for different types of borrowers: “homeowners” to refer to owner-occupants of residential property; “investors” to refer to borrowers with a loan secured by non-owner-occupied residential property other than larger apartment buildings; and “commercial borrowers” to refer to borrowers with a mortgage on large apartment buildings, commercial or other nonresidential property. Most mortgage loans are secured by residential property, and foreclosures are also overwhelmingly of residential property loans.<sup>157</sup> Studies of foreclosures in certain localities have shown commercial property loans constituting between about 4% and 18% of foreclosures.<sup>158</sup>

Residential home loans are mostly for homeowners rather than investors, although the ratio of loans between homeowners and investors has changed in the last few years.<sup>159</sup> The percentage of residential home loans for non-owner-occupied properties increased from the range of 5% to 6% in the early and

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153. FREDDIE MAC, FORECLOSURE AVOIDANCE RESEARCH 3 (2005), available at [http://www.freddiemac.com/service/msp/pdf/foreclosure\\_avoidance\\_dec2005.pdf](http://www.freddiemac.com/service/msp/pdf/foreclosure_avoidance_dec2005.pdf).

154. *Id.* at 4. Homeowners in default had less income than those in good standing, but the gap was relatively small—\$52,400 versus \$56,700. This might be explained by the fact that borrowers in good standing were much more likely to be older (38% to 12%) and retired (32% to 7%). *Id.*

155. *Id.*

156. Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL’Y DEBATE 533, 544–50 (2004) (explaining that subprime borrowers are less likely to have done comparative shopping for the best rate and terms).

157. See, e.g., BALTIMORE, *supra* note 62, at 9 (disclosing that a significant portion of foreclosures were residential); Wechsler, *supra* note 118, at 872 (observing that a majority of loans were residential).

158. BALTIMORE, *supra* note 62, at 9 (indicating that a study of more than five years of loans in the City of Baltimore, Maryland, found 96.2% of 22,839 loans in foreclosure were for residential property); Wechsler, *supra* note 118, at 865, 872 (analyzing a study of Onondaga County, New York, which identified 18% of 118 properties in foreclosure were loans secured by commercial property).

159. Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 FED. RES. BULL. A123, A134–35 (2006), available at <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>.

mid-1990s to 8.6% in 2001.<sup>160</sup> Non-owner-occupied residential lending then rose dramatically each year from 2002 through 2005, reaching 17.3% of residential loans for 2005.<sup>161</sup> These numbers include investor properties intended for rental and second homes, a percentage of which are not rented.<sup>162</sup> A report of certain securitized loan originations showed this same sharp upward trend in “nontraditional” investor loans.<sup>163</sup> Investor loans grew from 1.8% to 8.9% of the dollar volume of all loans from 2001 to 2006.<sup>164</sup>

Recent studies reveal a higher percentage of foreclosed loans are investor-owned properties in urban areas with concentrated foreclosures.<sup>165</sup> The Mortgage Banker’s Association has reported that investor loans account for 18% of subprime loan defaults in the third quarter of 2007.<sup>166</sup> The rate varied drastically by state and by type of loan, ranging as high as 35% for prime, adjustable rate foreclosures in Montana.<sup>167</sup> Of the single-family residential loans in foreclosure in a study of Saint Paul, Minnesota, foreclosures from January 2005 through September 2006, only 58.8% appeared to be owner-occupied.<sup>168</sup>

The high percentage of investor loans in foreclosure may be explained, at least in part, by evidence indicating that investor properties with subprime loans are much more likely to be foreclosed than residential owner-occupied properties.<sup>169</sup> A study of foreclosures in the Chicago area in 2002 showed that subprime investor loans were almost three times more likely to result in foreclosure than subprime loans to homeowners.<sup>170</sup> This is

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160. *Id.*

161. *Id.*

162. *Id.* at A134 & n.19.

163. Thompson, *supra* note 46, at 20. The study defined nontraditional loans as interest-only and negative amortization loans.

164. *Id.* Interestingly, the share of second home loans decreased slightly from 6.9% to 4.7%. *Id.* In subprime loans, the Thompson study found that the investor share of subprime held steady from 2001 and 2006 at between 5.0% and 5.7%, although second home share of the analyzed subprime loans increased from 0.8% in 2001 to 1.5% in 2006. *Id.* at 18.

165. DUDA & APGAR, *supra* note 40, at 7.

166. JAY BRINKMANN, MORTGAGE BANKERS ASSOC., AN EXAMINATION OF MORTGAGE FORECLOSURES, REPAYMENT PLANS AND OTHER LOSS MITIGATION ACTIVITIES IN THE THIRD QUARTER 2007, at 10 (2008), [http://www.mortgagebankers.org/files/news/internalresources/59454\\_LoanModificationsSurvey.pdf](http://www.mortgagebankers.org/files/news/internalresources/59454_LoanModificationsSurvey.pdf).

167. *Id.*

168. This analysis is based on data from the Saint Paul, Minnesota City Council Research Department.

169. See, e.g., IMMERGLUCK & SMITH, *supra* note 61, at 18 (describing propensity towards foreclosure for investor-owned properties in Chicago).

170. *Id.* at 18–20, 28.

explained, at least in part, by the fact that investors in residential properties are more likely to walk away from a property in default than a homeowner who occupies the property.<sup>171</sup>

b. *Experience of Borrowers in Foreclosure.* For many homeowners, their primary or even sole focus entering foreclosure is maintaining ownership of their particular home.<sup>172</sup> The family may be rooted in the house where they are raising their children, the neighborhood where they have found a sense of belonging, or a home they built. These familial or emotional attachments to a home can be of overwhelming importance to borrowers. Investors and commercial borrowers can be presumed typically not to have such attachments, but rather to treat their decisions in foreclosure solely as a matter of financial interest. Homeowners, of course, also have financial interests in the property, and the relative importance to default and foreclosure of financial calculations and attachment to the home is the subject of debate among scholars, especially economists.<sup>173</sup>

A triage can be applied to homeowners who enter foreclosure: (1) those who have or may have the income and debt structure that afford them a reasonable chance to maintain ownership of the property; (2) those who have no reasonable chance to survive foreclosure as owners, but have equity in the home; and (3) those without equity in the home who either have no reasonable chance to maintain ownership or no interest in maintaining ownership. Each of these groups faces different choices and experiences in foreclosure.

Homeowners in the first group are poised to take advantage of one or more of the many options for saving ownership of their homes. These options include a loan workout through modification or forbearance, a reinstatement loan, or a refinance loan, including a reverse mortgage.<sup>174</sup> Some homeowners also may be able to maintain ownership through a lawsuit asserting fraud

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171. Gerardi et al., *supra* note 42, at 20.

172. See FREDDIE MAC, *supra* note 153, at 10–11 (indicating a strong preference by homeowners in default for exploring only options that allow them to retain ownership).

173. See CAPONE, *supra* note 143, at 14 (noting debate over whether or not borrowers act in a “ruthless” manner and citing study of FHA data that shows this effect exists when housing prices decline, but that generally borrowers default in response to “trigger” events, such as job loss or divorce); see also Jacoby, *supra* note 90, at 329 n.23 (collecting sources indicating that homeowners in default are reluctant to give up ownership even when financial circumstances would suggest renting is preferable). Most of the studies on the “ruthlessness” of borrowers do not account for different conduct among subgroups of borrowers, such as separating owner-occupants from investors.

174. See CAPONE, *supra* note 143, at 15.

or violation of consumer protection laws, such as the Truth in Lending Act.<sup>175</sup>

Empirical studies suggest that these homeowners are traditionally the largest of the three types of borrowers in foreclosure.<sup>176</sup> Depending on the sample of loans studied, between about one-third and two-thirds of homeowners were able to reinstate their loans or otherwise cure the default and maintain ownership.<sup>177</sup>

An obstacle to maintaining homeownership for this group of borrowers is that they are often unaware of the alternatives available to them.<sup>178</sup> A survey of homeowners in default by Freddie Mac found a significant lack of understanding about their options in the foreclosure process.<sup>179</sup> Almost one-third, 31%, of homeowners in default had not contacted their lender to discuss the default, often for reasons that suggested ignorance of possibly useful assistance.<sup>180</sup> While 74% of delinquent homeowners knew that they could pay off their loan in a lump sum, only 36% to 61% were aware of a variety of other options at the discretion of the lender for dealing with the foreclosure.<sup>181</sup> For instance, only 36% of delinquent homeowners said they knew

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175. See 15 U.S.C. § 1635 (2006) (providing a right to rescind a loan in violation of certain provisions of the Truth in Lending Act).

176. See Gardner & Mills, *supra* note 152, at 56 (noting a research study where nearly 28% of borrowers in 90-day default lost their homes, another 37% cured the default, and the remaining 35% were able to sell their properties); see also BALTIMORE, *supra* note 62, at 33 (indicating that 30% of Baltimore foreclosures retain ownership and 54% of New Castle County, Delaware foreclosures maintain ownership); NEIGHBORHOOD HOUS. SERVS. OF CHI., INC., HOME-OWNERSHIP PRESERVATION INITIATIVE, MID TERM REPORT FOR THE CHICAGO HOMEOWNERSHIP PRESERVATION INITIATIVE 16 (2004), <http://www.knowledgeplex.org/showdoc.html?id=90881> [hereinafter HOPI] (reporting that 690 of 1,934, or about 36%, of homeowners in foreclosure who received counseling in an eighteen-month period were able to save ownership of the home); SCHLOEMER ET AL., *supra* note 40, at 12–13 (estimating that slightly more than half of the number of loans that entered foreclosure at least once completed foreclosure for the period 1998–2001; for example, 22.9% of subprime loans originated in 2000 entered foreclosure at least once, but only 12.9% completed foreclosure). Of course, the relative size of the three groups will shift with changing economic conditions. When housing prices are appreciating rapidly, the number of homeowners in foreclosure with equity will be higher. When housing prices are declining, homeowners are less likely to have realizable equity in the home. The differing characteristics of subprime loans also likely would serve to decrease the size of this group of foreclosed borrowers.

177. See Ambrose & Capone, *supra* note 146, at 106. (finding that the vast majority of FHA loan defaults studied ended in loan reinstatement, and that even after foreclosure was initiated, the completion rate on the foreclosure was less than 55%).

178. See FREDDIE MAC, *supra* note 153, at 9 (indicating in a Freddie Mac study that at least 17% of delinquent homeowners either didn't know who to call or refused).

179. *Id.*

180. *Id.*

181. *Id.* at 10.

about the possibility of forbearance agreements, and only 53% stated that they knew lenders could extend the term of the mortgage.<sup>182</sup>

The Freddie Mac survey also determined that 64% of homeowners in default were unaware of the existence of foreclosure counseling, and 74% of these homeowners indicated a likeliness to use such services once made aware of their existence.<sup>183</sup> Foreclosure counselors assist homeowners by collecting and analyzing documentation and making the borrower aware of all the options available for handling the situation, matching homeowners in foreclosure with available resources, and advocating with lenders and others on behalf of the homeowner.<sup>184</sup> By helping to identify appropriate workout options, this process can be of benefit to the lender as well.<sup>185</sup> Foreclosure counselors usually are part of a nonprofit entity, and the method and quality of services varies by location.<sup>186</sup>

There is little comprehensive research on the effectiveness of debt counseling, but the information that is available generally supports the use of such programs.<sup>187</sup> The same is true of homeownership counseling and, specifically, counseling for homeowners in foreclosure.<sup>188</sup> Available studies on foreclosure counseling indicate some success in helping homeowners retain ownership.<sup>189</sup>

182. *Id.*

183. *Id.*

184. CHRISTI BAKER ET AL., FANNIE MAE FOUND., ESSENTIAL COMPONENTS OF POST-PURCHASE PROGRAM MODELS 5 (2004), available at <http://www.knowledgeplex.org/showdoc.html?id=42132>; see also HOPI, *supra* note 176, at 15 (“NHS counselors assist delinquent borrowers in exploring all options available to them to maintain homeownership and/or avoid foreclosure including loan modification, forbearance, NHS reinstatement loans, HOPI refinance specialty products, reverse mortgage, and sale of the property.”); ALAN MALLACH, FEDERAL RESERVE BANK OF PHILA., HOME OWNERSHIP EDUCATION AND COUNSELING: ISSUES IN RESEARCH AND DEFINITION 25–26 (2000), available at <http://www.philadelphiafed.org/ccca/capubs/homeowner.pdf>.

185. HOPI, *supra* note 176, at 15.

186. CHRISTI BAKER ET AL., CURRENT STATE OF POST-PURCHASE PROGRAMS 7 (2004), available at <http://www.knowledgeplex.org/showdoc.html?id=42132> [hereinafter CURRENT STATE]; MALLACH, *supra* note 184, at 25–26.

187. See CURRENT STATE, *supra* note 186, at 5–6; David A. Lander, *A Snapshot of Two Systems that are Trying to Help People in Financial Trouble*, 7 AM. BANKR. INST. L. REV. 161, 175 (1998).

188. CURRENT STATE, *supra* note 186, at 9–13; MALLACH, *supra* note 184, at 4–16 (collecting studies on homeownership counseling and noting problems with data collection and study design).

189. See Todd & Grover, *supra* note 141, at 2 (noting that Minneapolis–Saint Paul foreclosure prevention services consistently report a success rate of one-half of clients in default avoiding foreclosure); see also HOPI, *supra* note 176, at 15. *But see* MALLACH, *supra* note 184, at 7–8 (questioning methodology of all studies of foreclosure prevention counseling and noting that demonstrated success was modest).



The second group, those with equity but no realistic chance of maintaining ownership, have only one rational choice—attempt to sell the property and recover the equity.<sup>190</sup> Unfortunately, these homeowners are the primary target of a widespread problem known as foreclosure equity stripping or foreclosure rescue scams.<sup>191</sup> Homeowners who enter foreclosure are saturated with mail, phone calls, and personal visits from would-be rescuers promising to save the home from foreclosure.<sup>192</sup> Typical solicitations include promises such as: “We Can Save Your Property and Even Give You Cash In Hand;”<sup>193</sup> “We can stop the foreclosure process;” and “We can help you restore your credit.”<sup>194</sup> Because the foreclosure process and all liens on the property are subjects of public record, those interested in perpetrating a foreclosure rescue scam have a readily identifiable market of homeowners in foreclosure likely to have equity in their homes. A common result of foreclosure rescue scams is that the homeowner loses all ownership and equity in the home, and often is evicted as a tenant.<sup>195</sup>

Homeowners who have neither substantial equity in the property nor any realistic hope of retaining ownership are the

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190. For a sale of the home to be the only rational choice, there must be net equity; i.e., the amount of home equity must be sufficient to be positive after accounting for selling expenses. There may be other considerations for the homeowner, such as the possibility of a deficiency judgment that could be avoided by sale of the property or the benefit to the borrower of extending the free rent to the very end of the foreclosure period, which is less likely with a sale of the home.

191. See STEVE TRIPOLI & ELIZABETH RENUART, DREAMS FORECLOSED: THE RAMPANT THEFT OF AMERICANS' HOMES THROUGH EQUITY-STRIPPING FORECLOSURE “RESCUE” SCAMS (2005), <http://www.consumerlaw.org/news/ForeclosureReportFinal.pdf> (finding that these programs target homeowners with equity); Prentiss Cox, *Foreclosure Equity Stripping: Legal Theories and Strategies to Attack a Growing Problem*, 39 CLEARINGHOUSE REV. 607, 607–08 (2006) (noting the problem is occurring across the country, particularly as home prices rise and homeowners find themselves with greater equity); Creola Johnson, *Stealing the American Dream: Can Foreclosure-Rescue Companies Circumvent New Laws Designed to Protect Homeowners from Equity Theft?*, 2007 WIS. L. REV. 649, 655 (2007) (stating that these persistent economic conditions lure “con artists”). Homeowners in the first group, with realistic options for maintaining homeownership and who have equity in the property, also fall victim to foreclosure equity stripping scams.

192. See TRIPOLI & RENUART, *supra* note 191, at 9 (explaining the various methods scammers use to contact homeowners).

193. Complaint, *Johnson v. Home Savers Consulting Corp.*, No. 04-5427 (E.D.N.Y. 2004).

194. Complaint, *State v. HJE*, No. 03-05554 (D. Minn. 2003); see also TRIPOLI & RENUART, *supra* note 191, at 55–62 (collecting solicitations and related material); Cox, *supra* note 191, at 610–11 (describing foreclosure rescue solicitation process).

195. See TRIPOLI & RENUART, *supra* note 191, at 8–39 (describing the experience of eighteen different states with foreclosure equity stripping problems); Cox, *supra* note 191, at 611–14 (describing the details of typical equity stripping schemes).

final group (hereinafter “lost homeowners”). Lost homeowners have little incentive and likely have few resources to invest in home maintenance.<sup>196</sup> These homeowners have an incentive to stay in the home through the end of the foreclosure period because there is no cost to doing so.<sup>197</sup> Despite this fact, many homeowners abandon their homes during the foreclosure process, creating a problem with vacant properties.<sup>198</sup>

In states allowing deficiency judgments, homeowners theoretically may have an incentive to minimize the lender’s loss on the property by negotiating a deed-in-lieu of foreclosure or short sale in exchange for the lender forgoing deficiency proceedings.<sup>199</sup> Because of the rarity of use of deficiency judgments, this incentive may be of limited practical value.<sup>200</sup> Some of these homeowners may also use these mechanisms as a means to minimize damage to their credit profile.<sup>201</sup>

#### IV. EXISTING SCHOLARSHIP ON FORECLOSURE LAW

Most economists and legal scholars agree that current state foreclosure laws generally are not efficient. Economists focus much of their analysis on the costs imposed on lenders by state protections for borrowers in foreclosure. Legal scholars are more animated by the debate over the effectiveness of current foreclosure sale procedures.

##### A. *Foreclosure Laws from the Perspective of Economists*

Economists identify costs imposed on lenders by foreclosure laws, including transaction costs (e.g., attorney’s fees), property costs (e.g., paying unpaid property taxes), and opportunity costs

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196. See, e.g., Louwagie & Howatt, *supra* note 6.

197. See, e.g., *id.*

198. See Dennis R. Capozza & Thomas A. Thomson, *Optimal Stopping and Losses on Subprime Mortgages*, 30 J. REAL ESTATE FIN. ECON. 115, 126 (2005) (suggesting subprime borrowers do not significantly take account of “free rent” in their responses to default).

199. See, e.g., BRIAN D. CUNNINGHAM, UTAH STATE BAR MID YEAR MEETING, REMEDIES UNDER ARTICLE 9 OF THE UCC: DEED IN LIEU OF FORECLOSURE AND SECRET LIENS 7 (2008), [http://www.utahbar.org/cle/springconvention/materials/remedies\\_article9.pdf](http://www.utahbar.org/cle/springconvention/materials/remedies_article9.pdf) (noting that in Utah, a deficiency judgment state, lenders will accept a deed-in-lieu of foreclosure in exchange for an agreement not to sue the mortgagor for the deficiency on the home).

200. See Nelson & Whitman, *supra* note 91, at 1428–29.

201. See RAO ET AL., *supra* note 21, at § 2.14. (detailing how homeowners sometimes overestimate the value of a short sale or deed-in-lieu as protection against adverse credit report data. The difference, credit wise, between a completed foreclosure and a terminated foreclosure is not significant).

(e.g., interest foregone during the process).<sup>202</sup> Differences in foreclosure laws will result in differences in each of these types of costs. Any aspect of state foreclosure law that causes delay will increase the opportunity costs of the lender. Economists generally conclude that judicial foreclosure, a statutory right of redemption, and antideficiency laws increase lender costs.<sup>203</sup>

The results of economic studies provide support for the notion that lenders suffer more losses in states with judicial foreclosure, statutory redemption periods, and antideficiency legislation.<sup>204</sup> Yet the economic studies are less conclusive on the actual effect of these added loan losses on terms and availability of mortgage credit.<sup>205</sup> The study estimates increases in the cost of mortgage loans in states with judicial foreclosure, redemption periods, and antideficiency legislation range from substantial to almost nonexistent.<sup>206</sup>

Recently, Karen Pence concluded that "loan sizes are 3% to 7% smaller in states that require judicial foreclosure."<sup>207</sup> The article, entitled *Foreclosing on Opportunity: State Laws and Mortgage Credit*, suggests that this result means that borrowers

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202. Terrence M. Clauretie & Thomas Herzog, *The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry*, 22 J. MONEY CREDIT & BANKING 221, 222 (1990).

203. See Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 REV. ECON. & STAT. 177, 180 (2006) (estimating that loan sizes are smaller in judicial foreclosure states and concluding that this reflects a reduced supply of credit); see also Terrence M. Clauretie, *State Foreclosure Laws, Risk Shifting, and the Private Mortgage Insurance Industry*, 56 J. RISK & INS. 544, 552 (1989) (concluding that judicial foreclosure, statutory right of redemption, and antideficiency statutes add significantly to mortgage risk); Clauretie & Herzog, *supra* note 202, at 231 (predicting borrowers in more protective states eventually will pay higher private mortgage insurance premiums); Charles M. Kahn & Abdullah Yavas, *The Economic Role of Foreclosures*, 8 J. REAL EST. FIN. & ECON. 35, 46 (1994) (arguing that mortgagor protection laws have substantial effects on the market); Richard A. Phillips & James H. VanderHoff, *The Conditional Probability of Foreclosure: An Empirical Analysis of Conventional Mortgage Loan Defaults*, 32 REAL EST. ECON. 571, 584 (proposing that less protective laws will reduce costs and will lower interest rates); cf. Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 493-502 (1991) (finding that state mortgage protection laws impact interest rates less than prior studies indicated).

204. See Clauretie & Herzog, *supra* note 202, at 222-23; see also Pence, *supra* note 203, at 177 nn.2-3.

205. Cf. Mark Meador, *The Effects of Mortgagee Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143 (1982); Schill, *supra* note 203, at 507 (finding in one study that the cost of mortgage loans is substantially greater in states with judicial foreclosure, redemption periods, and antideficiency legislation, whereas in another study there is no significant increase in mortgage costs).

206. Cf. Meador, *supra* note 205, at 146-47; Schill, *supra* note 203, at 507.

207. Pence, *supra* note 203, at 180. Pence controls for a variety of factors by including a large number of variables in her regression analysis, but omits varying state laws regulating the terms of mortgage loans, such as prepayment penalty prohibitions, limits on loan fee charges, and special high-cost mortgage. *Id.*

in states with judicial foreclosure “may pay more for their mortgages, purchase smaller houses, or have difficulty becoming homeowners.”<sup>208</sup> Interestingly, Pence found no significant adverse relationship between loan size and either statutory redemption rights or antideficiency laws.<sup>209</sup> Also, borrowers in judicial foreclosure states were slightly less likely to be rejected for a mortgage loan in her study.<sup>210</sup>

### *B. Foreclosure from the Perspective of Legal Scholars*

Most legal scholarship focuses on the mechanics of foreclosure procedures. A series of law review articles have portrayed foreclosure law as the struggle between the need for borrowers to recover their home equity and efficiency for lenders in recovering their investment at a reasonable cost.<sup>211</sup> Proposals decrying the inefficiency of the foreclosure sale process have been especially popular.<sup>212</sup> The vast majority of these commentators have concluded either that the foreclosure sale procedure should be reformed to imitate nonforeclosure market methods; or that property in foreclosure should be sorted by an appraisal procedure or other method, and lenders allowed to quickly take title to properties with no remaining equity; or both.

Two prominent scholars in the area of real estate finance and foreclosure law, Grant S. Nelson and Dale A. Whitman, suggest that a primary goal of foreclosure reform is to produce “more frequent and larger surpluses” from foreclosure sales.<sup>213</sup>

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208. *Id.* at 182.

209. *Id.*

210. *See id.* at 180.

211. *See* NELSON & WHITMAN, *supra* note 100, at 228–60 (identifying general characteristics of the judicial foreclosure procedure); Robert J. Aalberts & Douglas S. Bible, *Mortgage Default in Louisiana: An Empirical Study of Recent Foreclosures on Residential Property in Caddo Parish*, 15 S.U. L. REV. 215 (1988) (analyzing foreclosure law in Caddo Parish, Louisiana); Lawrence Berger, *Solving the Problem of Abusive Mortgage Foreclosure Sales*, 66 NEB. L. REV. 373 (1987) (looking broader at how states have dealt with foreclosure sale prices and deficiency judgments); Pamela Giss, *An Efficient and Equitable Approach to Real Estate Foreclosure Sales: A Look at the New Hampshire Rule*, 40 ST. LOUIS U. L.J. 929, 968 (1996) (observing foreclosure law through the lens of a small Northeastern state); Alex M. Johnson, Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy*, 79 VA. L. REV. 959 (1993) (assessing foreclosure law through an economic approach); Stark, *supra* note 91 (evaluating state and federal foreclosure law); Robert M. Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 936–38 (1980) (citing the Uniform Land Transactions Act); Wechsler, *supra* note 118 (observing the present state of mortgage foreclosure law in the United States).

212. *See, e.g.,* Wechsler, *supra* note 118, at 884 (calling for reform in mortgage foreclosure law due to inefficiencies of foreclosure sale procedures).

213. NELSON & WHITMAN, *supra* note 100, at 703–04.

They argue for an independent official appointed to sell homes using real estate brokers and other staples of market sale tactics.<sup>214</sup> More recently, Nelson and Whitman write approvingly of the proposed foreclosure sale procedures in the Uniform Nonjudicial Foreclosure Act (UNFA).<sup>215</sup> They describe the deficiencies of the current auction process at protecting borrower equity.<sup>216</sup> Despite noting that "loss of significant equity does not occur for a large percentage of debtors," they state that "[a] principal goal of foreclosure reform should be to alleviate these cases."<sup>217</sup> The UNFA proposes improved procedures for foreclosure auctions and two alternative procedures: either negotiated sale or by appraisal.<sup>218</sup>

Basil H. Mattingly offers a characteristic argument for legal scholars of foreclosure.<sup>219</sup> Mattingly conceptualizes foreclosure law as "a study of power," and states that "the evolution in foreclosure law can be understood by the power struggle between borrowers and lenders."<sup>220</sup> Mattingly proposes that lenders be required to sell the property in either "a commercially reasonable manner" or conduct the sale according to a statutorily mandated regime designed to ensure maximum opportunity for competitive bidders.<sup>221</sup> Mattingly also would offer foreclosing lenders a third option of strict foreclosure if the borrower and certain junior lien holders fail to object.<sup>222</sup>

Two legal scholars, Steven Wechsler and Deborah P. Stark, have conducted empirical studies of the foreclosure sale process.<sup>223</sup> Wechsler studied foreclosure sales in Onondaga

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214. *Id.*; see also Grant S. Nelson, *Deficiency Judgments After Real Estate Foreclosures in Missouri: Some Modest Proposals*, 47 MO. L. REV. 151, 163 (1982) (calling for reform in foreclosure sales and the appointment of an independent trustee).

215. Nelson & Whitman, *supra* note 91, at 1430, 1446. Nelson and Whitman note the fairly modest suggestions for reforming existing auction procedures in the UNFA and attribute this result to a political calculation by the drafters that lenders would not support broader changes and the power of lenders to stop any legislative changes they oppose. *Id.* at 1430. Nelson and Whitman argue that the non-auction alternative sale procedures in the UNFA are a positive improvement and offer "significant advantages to creditors over the conventional auction sale." *Id.* at 1446.

216. *Id.* at 1429.

217. *Id.*

218. UNFA, *supra* note 96, at §§ 4–5 (detailing proposed methods for negotiated sale and appraisal).

219. See generally Mattingly, *supra* note 97.

220. *Id.* at 89.

221. See *id.* at 120–24.

222. *Id.* at 114–20.

223. See Stark, *supra* note 91 (evaluating state and federal foreclosure laws); Wechsler, *supra* note 118 (analyzing foreclosure by sale as a form of strict foreclosure); see also Aalberts & Bible, *supra* note 211 (observing Louisiana foreclosure law).

County, New York, in 1979.<sup>224</sup> Wechsler found that the winning bidder at the sale was the foreclosing lender 77% of the time, but in almost all cases the winning bid was by a third party buyer when the sale produced a surplus; in other words, a sale amount greater than the amount owed to the foreclosing lender.<sup>225</sup> After taking title to the property, foreclosing lenders re-sold the property for an amount greater than their investment in about half of the cases, but lost money overall after re-selling the properties.<sup>226</sup> Third party buyers, in contrast, successfully produced a profit on 14 of 15 re-sales.<sup>227</sup> Wechsler concluded that foreclosure sales should be “changed to more closely resemble an ordinary retail real estate sale, rather than a forced auction sale.”<sup>228</sup> Alternatively, Wechsler proposed that the lender assume title to the property without the necessity of sale when a required appraisal determines there is no borrower equity.<sup>229</sup>

Stark argues that Wechsler focuses too much attention on whether foreclosure procedures produce a fair market price for the property in foreclosure.<sup>230</sup> She states that the goal of foreclosure law should be to “balance the interest of lenders and all nondefaulting borrowers in an efficient foreclosure process against the interest of borrowers who default in a process which provides a true opportunity and means to protect any equity they have in the property.”<sup>231</sup> Stark analyzes foreclosure sale data from Cook County, Illinois, in 1993 and 1994 to determine the validity of “[t]wo basic criticisms of the foreclosure process”—whether the sale process is unfair or inefficient.<sup>232</sup> She concludes that most borrowers with equity in the property take action to reinstate or

224. Wechsler, *supra* note 118, at 851.

225. *Id.* at 876 (“The sales left deficiency amounts in 94 of the 118 foreclosures, or about eighty percent of the total. A deficiency was much more likely to result when the mortgagee, rather than a third party, was the buyer at foreclosure. Ninety-two percent of the sales to mortgagees left deficiencies, as opposed to thirty-nine percent of the sales to third parties. Moreover, the deficiencies in the third-party cases tended to be relatively small: about half amounted to less than \$5,000, and only one exceeded \$18,000. The deficiency amounts left by mortgagee purchases ranged from less than \$1 to more than \$2 million. Only one sale to a mortgagee produced a surplus, and that surplus was only \$1,400. In contrast, fifty-four percent of the sales to third parties generated surpluses to be paid to the mortgagor or junior lienors. Two-thirds of these surpluses amounted to more than \$5,000.”).

226. *Id.* at 876. It is important to note that Wechsler does not appear to account for improvements or carrying costs.

227. *Id.* at 883.

228. *Id.* at 893.

229. *Id.* at 894–95.

230. Stark, *supra* note 91, at 235–36 nn.35–38.

231. *Id.* at 236.

232. *Id.* at 235.

otherwise terminate the foreclosure process before losing all ownership rights, although there was lost equity in a small number of egregious cases.<sup>233</sup> Despite disagreeing with Wechsler about the extent and importance of “lost equity” for the borrowers, Stark argues for a procedure based on appraisals that is similar to one of the proposals made by Wechsler.<sup>234</sup>

Alex Johnson notes the emphasis in legal scholarship on the foreclosure sale procedures and suggests that “recent scholarship analyzing the foreclosure process would lead any reasonably intelligent reader to conclude that the primary and perhaps sole purpose of the process is to provide competitive bidding in order to protect the mortgagor’s equity interest.”<sup>235</sup> He argues that the primary purpose of the foreclosure system should be to inexpensively terminate the borrower’s equitable redemption right and liquidate the collateral.<sup>236</sup> Johnson looks to the norms of bankruptcy for a new foreclosure system.<sup>237</sup> The foreclosure procedure he suggests, nonetheless, is similar to the recommendations of other legal scholars.<sup>238</sup> Johnson proposes that a trustee be appointed to determine whether the property has remaining equity based on estimated market value, and that the trustee should sell such properties in a manner that maximizes the price.<sup>239</sup>

### C. *Limited Importance of Foreclosure Sales*

The focus of much of legal scholarship on the adequacy of foreclosure sale procedures has led to a formalistic debate of limited relevance in practice.<sup>240</sup> The sale procedure simply does

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233. *Id.* at 244–45.

234. Compare Wechsler, *supra* note 118, at 894–95 (arguing that a statute could empower the court to require an independent appraisal of the current retail market value of the property. If the appraisal showed the property to be worth less than the amount of the debt, the mortgagee could foreclose without a sale.), with Stark, *supra* note 18, at 686 (calling for a bifurcated foreclosure system where a lender may elect a strict foreclosure if an appraisal indicates the fair market value does not exceed the final debts).

235. Johnson, *supra* note 211, at 978, 988.

236. *Id.* at 989.

237. *Id.* at 1001–02.

238. See *id.* at 1004–05.

239. *Id.* at 1014–19. Johnson’s proposal is that borrowers be required to bring a state court action in order to obtain the appointment of a trustee, who would then stay the proceeding if there appeared to be equity in the property. *Id.* at 1014–15. Johnson then seems to assume that borrowers would routinely file such actions. *Id.* at 1014. As a practical matter, it is doubtful that many residential owner-occupants would have access to the legal assistance that would enable them to file such court actions.

240. See, e.g., Mattingly, *supra* note 97, at 81 (noting that different foreclosure models have been proposed in an attempt to balance both borrower and lender’s interests); Schill, *supra* note 203, at 492 (noting that the development of real estate

not matter in the vast majority of foreclosure cases.<sup>241</sup> Even when the sale is of consequence, restructuring foreclosure to increase market bidding and to sort borrowers with remaining equity is only one concern, and not likely a central issue, to broader public interests in housing and community quality of life.

The foreclosure sale process matters only if the borrower is unable to reinstate or redeem the loan, refinance the loan, sell the property, or otherwise resolve the foreclosure prior to sale.<sup>242</sup> Most homeowners will likely resort to one of these options. Stark's analysis of Cook County foreclosures, for instance, found that in over two-thirds of the cases the foreclosure did not result in a sale.<sup>243</sup> Returning to the idea of a triage of borrowers, this means only the lost homeowners, those without either the resources to maintain ownership or equity in the property, or those in the more fortunate two groups who for some reason do not successfully execute a rescue or sale strategy, will face a foreclosure sale.<sup>244</sup>

When the sale does proceed, the borrower has an interest in realizing equity from the home or in avoiding or minimizing a deficiency judgment.<sup>245</sup> A deficiency judgment does not exist when an antideficiency statute applies to the foreclosure.<sup>246</sup> Even where a deficiency judgment is possible, deficiency judgments are rarely pursued by the lender.<sup>247</sup> A deficiency judgment often will be hard to collect because many borrowers in foreclosure presumably will have few assets that are not exempt from collection, as well as

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finance law has been marked by the attempt to balance between borrowers and lenders rights).

241. See Johnson, *supra* note 211, at 959 (stating that in the majority of cases, the foreclosure sale will produce an inadequate sale price); see also Robert M. Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 848 (1980) (asserting that judicial has the same consequences as strict foreclosure).

242. In several states, foreclosure laws make the sale all but irrelevant, regardless of the homeowner's ability to resolve the foreclosure. See NELSON & WHITMAN, *supra* note 100, at § 7.1 (explaining that statutory redemption rights permit the mortgagor to redeem after a valid foreclosure sale). In our hypothetical State A, for example, a sale prior to the statutory redemption right makes the foreclosure sale irrelevant because the incentives for all parties is to have the lender make the only bid at sale for the amount of the debt.

243. Stark, *supra* note 91, at 242–43.

244. Stark, *supra* note 18, at 677 (stating that in the majority of cases the borrower protects her equity in the property by either reinstating the loan or by redeeming the property prior to foreclosure).

245. See James B. Hughes, Jr., *Taking Personal Responsibility: A Different View of Mortgage Anti-Deficiency and Redemption Statutes*, 39 ARIZ. L. REV. 124, 125 (1997) (stating that antideficiency protections protect mortgagors when foreclosure sale proceeds are insufficient to retire the mortgagor's debt).

246. See *id.*

247. See Wechsler, *supra* note 118, at 895–96.



other debts.<sup>248</sup> Even if a lender succeeds in winning a deficiency judgment, it is an unsecured debt that is dischargeable in bankruptcy.<sup>249</sup>

This leaves the borrower's interest in realizing the equity in his or her home following the foreclosure sale; it is this issue that seems to animate much of the commentary on foreclosure law.<sup>250</sup> Depriving homeowners of their equity through defective sale procedures is a matter of concern, but there are not that many properties that proceed to a foreclosure sale in which the home has any remaining equity.<sup>251</sup> Stark determined that in 90% of examined foreclosure sales, the fair market value of the property was less than the outstanding loan amount.<sup>252</sup> Similarly, Wechsler found only about 80% of foreclosure sales ended in a deficiency.<sup>253</sup> In other words, most of the foreclosure sales probably occur with borrowers in the worst-off group who have no equity and no means to retain ownership.<sup>254</sup> Even where some equity exists at the time of the foreclosure sale, for the homeowner in a nonforced sale to have realized the equity, it must have been substantial enough to allow for a profit after sale costs so the borrower cannot be said to have been deprived of the equity.<sup>255</sup>

Narrowing the issue to cases in which the foreclosure process goes through to a sale and the borrower has sufficient equity to have obtained money from a voluntary sale, the loss of equity is not necessarily a function of flawed foreclosure sale procedures.<sup>256</sup> Most borrowers with equity will best avoid any inequities in the foreclosure sale process by listing their property for sale rather than relying on the foreclosure sale to recover their equity.<sup>257</sup> The borrower can control the seller's side of the

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248. *Id.*

249. Jacoby, *supra* note 90, at 328.

250. See Johnson, *supra* note 211, at 959–60.

251. See Stark, *supra* note 91, at 244 (stating that only in only a small percentage of cases does a foreclosure sale cause a loss of equity for the mortgagor).

252. *Id.*

253. Wechsler, *supra* note 118, at 876.

254. See Stark, *supra* note 91, at 245 (concluding that in approximately 90% of the cases, the borrower had no equity in the property at foreclosure).

255. Nor is there empirical support for the notion that lenders profit in any substantial amount from manipulating foreclosure sales. Compare Wechsler, *supra* note 118, at 882 (concluding that lenders made a profit in about half of resales), with Stark, *supra* note 91, at 244 (finding in only 12% of foreclosure sales cases did the lender make a profit upon resale).

256. See Johnson, *supra* note 211, at 971–72 (stating that the mortgagee's only priority at the foreclosure sale is to make itself whole).

257. See *id.* at 974 (providing an example of a mortgagor protecting her equity by selling her property herself).

sale process.<sup>258</sup> The obvious impediment to borrower disposition of the property is a lack of time to complete the sale during the foreclosure process.<sup>259</sup> In Georgia, for instance, the borrower can lose title to the property in as little as two months or less from the notice of default.<sup>260</sup> Yet a borrower losing equity in this type of rapid foreclosure procedure is a function of the trade-offs in that state's law favoring lender's interests in quick conversion of their collateral rather than just the result of defects in the foreclosure sale method.<sup>261</sup>

## V. FORECLOSURE LAW AS HOUSING POLICY

This Article argues that state foreclosure laws should be evaluated by their impact on desired social outcomes for housing. The dispute over borrower protection versus credit availability is just one component of this evaluation. A broader public policy perspective yields priorities and ideas that don't fit well within the current boundaries of debate.

Foreclosure law affects two goals that have been integral to United States housing policy: (1) high levels of homeownership; and (2) community stability and housing quality.<sup>262</sup>

### A. Sustainable Homeownership

Homeownership, meaning ownership of a residence by its occupant, has been for decades an important social objective in the United States.<sup>263</sup> Increasing homeownership rates is a fundamental objective of public policy at every level of

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258. *See id.*

259. Wechsler, *supra* note 118, at 872 (finding that in 92% of cases, the time between the foreclosure action and the judgment was less than a year).

260. GA. CODE ANN. § 44-14-180 (2007); *see also* MORTGAGE DIRECTORY, *supra* note 19, at 1, 89; Bajaj, *supra* note 19.

261. Consider the Smith example above. The sale procedures in State A are irrelevant because the foreclosure sale almost surely will result in a successful credit bid by the lender and there will be no other bidders. *See supra* Part III.B.2. In State B, the Smiths face a difficult situation for realizing their equity because they have a short period in which to try to refinance or sell the home. While reforms to the sale procedure may increase the chance that the Smiths will recover some equity, the difficult situation is forced on the Smiths by the rapid timeline of the foreclosure period, and extending the timeline will do more for the Smiths' efforts to retain their equity than reforming the sale procedure.

262. One could argue, of course, that there are other goals to national housing policy, such as nondiscrimination or stimulating economic production.

263. *See* MALLACH, *supra* note 184, at 1; Philip Halpern, *Creating Fair and Efficient Subsidies for Home Ownership*, 4 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 125, 125 (1995).

government.<sup>264</sup> The central mission of numerous nonprofit organizations is to increase homeownership.<sup>265</sup> Higher homeownership has been linked to lower crime, better health, and a variety of other social quality measures.<sup>266</sup> Although there is disagreement that homeownership is always beneficial,<sup>267</sup> there is little dispute that policymakers at all levels of government afford homeownership a central place in national housing goals.<sup>268</sup>

Foreclosure laws have both a direct and an indirect effect on homeownership.<sup>269</sup> The obvious direct effect of foreclosure law on homeownership is that foreclosure laws may provide rights or benefits to borrowers that make it possible for more borrowers to retain ownership.<sup>270</sup> Foreclosure laws that provide more time to borrowers, or allow the right of redemption, likely increases the percentage of borrowers in foreclosure that avoid loss of ownership.<sup>271</sup> These borrower protections also raise the costs of foreclosure for lenders and thus increase lender willingness to forebear or negotiate an alternative result to initiating or completing foreclosure.<sup>272</sup> Furthermore, homes lost in foreclosure

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264. See Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 394 (1994) (describing the role the federal government has played in directing capital into the mortgage market and encouraging people to purchase by giving tax incentives and special treatment in bankruptcy).

265. See, e.g., HomeSight, <http://www.homesightwa.org/> (last visited Sept. 5, 2008). There are similar organizations in most states. See, e.g., Neighborhood Housing Service of Chicago, <http://www.nhschicago.org/content/index.php> (last visited Sept. 5, 2008).

266. ROBERT D. DIETZ, THE SOCIAL CONSEQUENCES OF HOME OWNERSHIP 4 (2003), available at [http://www.newtowncdc.org/pdf/social\\_consequences\\_study.pdf](http://www.newtowncdc.org/pdf/social_consequences_study.pdf) (“[H]omeownership is positively associated with physical, mental and emotional health.”); NAT’L ASSOC. OF REALTORS, SOCIAL BENEFITS OF HOMEOWNERSHIP AND STABLE HOUSING 12 (2006), available at [http://www.realtor.org/Research.nsf/files/05 Social Benefits of Stable Housing.pdf/\\$FILE/05 Social Benefits of Stable Housing.pdf](http://www.realtor.org/Research.nsf/files/05%20Social%20Benefits%20of%20Stable%20Housing.pdf/$FILE/05%20Social%20Benefits%20of%20Stable%20Housing.pdf) (“Research on crime and homeownership shows that homeowners are far less likely to become crime victims.”).

267. See, e.g., Forrester, *supra* note 264, at 378 (stating the risks of home equity loans to borrowers are both financial and psychological); Jacoby, *supra* note 90, at 324–25 (noting that some scholars have suggested that homeownership and mortgage debt lead to poverty);

268. See Halpern, *supra* note 263, at 125.

269. See APGAR & DUDA, *supra* note 56, at 9 (stating that borrowers’ direct costs include monetary costs; indirect costs result from increased future borrowing costs as a result of poor credit quality).

270. See Stark, *supra* note 91, at 241–42 (stating that borrower protections initiated in some states are aimed at providing borrowers with a chance to protect any equity they have in their property).

271. See *id.*

272. See Schill, *supra* note 203, at 496 (asserting that mortgagor protection laws create higher costs). Conversely, the loss of a house in foreclosure from fewer borrower protections means the foreclosed homeowner will have financial and perhaps psychological obstacles to again achieving homeownership, thereby reducing future

may be more likely to go to an investor and thus drive down homeownership rates.<sup>273</sup>

An indirect affect of foreclosure laws on homeownership is their impact on mortgage lending activity.<sup>274</sup> Ready access to mortgage financing for prospective or existing homeowners rests in part on the ability of lenders to convert efficiently the home into cash on default by the homeowner.<sup>275</sup> The exact relationship between borrower protective provisions of foreclosure laws and the terms of credit has been hard to determine.<sup>276</sup>

While the indirect costs of foreclosure protections for lenders have been studied and decried by economists and legal scholars, almost no consideration has been given to whether borrower protections in foreclosure promote retention of homeownership.<sup>277</sup> An empirical study of whether borrowers in states with judicial foreclosure or with long redemption periods are more likely to retain homeownership would be very helpful in determining the relative benefits of foreclosure protections versus the costs imposed on credit price and availability.

There is increasing concern that homeownership be sustainable.<sup>278</sup> Low income and minority homeowners are more likely to obtain a subprime loan<sup>279</sup> and are more likely to lose ownership of their home.<sup>280</sup> Foreclosure has a negative effect on a borrower's credit status, and thus it is unlikely that foreclosed homeowners will be able to return to homeownership.<sup>281</sup> A study

homeownership rates.

273. BALTIMORE, *supra* note 62, at 33.

274. See Clauretie & Herzog, *supra* note 202, at 231 ("[S]tate foreclosure laws affect the risk of residential mortgage lending.").

275. See Stark, *supra* note 18, at 646 (asserting that the ability of lenders to recover collateral quickly saves the lender money and may reduce costs of restoring the property).

276. See *supra* note 205. A counter-veiling indirect benefit to homeownership may occur if borrower protections make homeowners more comfortable that they will be treated fairly (from their perspective) in foreclosure, although it is unlikely that this information would be meaningful *ex ante* to many borrowers.

277. See Clauretie & Herzog, *supra* note 202, at 221 (studying the effect of foreclosure laws on mortgage lending).

278. CURRENT STATE, *supra* note 186, at 1, 6 ("[There is] growing concern about the sustainability of homeownership for traditionally underserved populations."); see also MALLACH, *supra* note 184, at 2 ("Home-ownership initiatives that might lead to a disproportionately high level of abandonment and foreclosure in the future would be in the interest of neither the buyers, the lenders, nor the community as a whole."); Jacoby, *supra* note 90, at 327–28 (emphasizing the importance of studying of foreclosure prevention).

279. See *supra* notes 57–64 and accompanying text.

280. Todd & Grover, *supra* note 141 (collecting studies showing racial and income differences in sustaining homeownership).

281. See Mattingly, *supra* note 97, at 109 (noting the negative effect foreclosure has on a borrower's credit history).

in England cataloged the multiple adverse health and social consequences for borrowers facing foreclosure, including severe stress and social isolation.<sup>282</sup> One homeowner in north Minneapolis described the experience of owning a home and losing it in foreclosure:

It's been horrible, you know, because of the choices I made. I would not say owning a home is terrible, but the debt I got into and it was a downward spiral I felt I would never get out of . . . once you are vulnerable like that, these kinds of things can happen to you.<sup>283</sup>

It is not as simple, then, as weighing the net impact of foreclosure laws on homeownership.<sup>284</sup> If foreclosure laws help maintain families in homes, or raise costs in a way that prevents homeownership that will result in a future foreclosure, these results have social value distinct from the net overall level of homeownership.

### *B. Foreclosure Law Affects Community Stability and Housing Quality*

States have a strong public interest in maintaining stable and prosperous residential communities.<sup>285</sup> It only takes a drive through certain urban neighborhoods hard-hit by foreclosures to see the direct relationship between foreclosure and the quality of community life. Foreclosed homes are likely to suffer maintenance problems, and the increase in vacant properties as a result of rising foreclosures causes neighborhood deterioration.<sup>286</sup>

Foreclosure laws can encourage or permit deterioration or abandonment of houses in foreclosure.<sup>287</sup> Long foreclosure periods can result in deterioration of property when owners have little or

282. Sarah Nettleton & Roger Burrows, *When a Capital Investment Becomes an Emotional Loss: The Health Consequences of the Experience of Mortgage Possession in England*, 15 HOUSING STUD. 463, 467–68, 474–75 (2000).

283. Jeff Crump, *Performing Housing Markets: Sticky Fingers and Subprime Lending* (unpublished, on file with the Houston Law Review) (interviews by David Tyler Mackay, Department of Geography, University of Minnesota).

284. See Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 581 (2002) (observing that homeowners may experience psychological and emotional trouble due to the loss of their homes).

285. See 42 U.S.C. § 1441 (2000).

286. See *supra* notes 68–79 and accompanying text.

287. See Johnson, *supra* note 211, at 984 (asserting that in jurisdictions where the mortgagor remains in possession of the property there is a risk that the property will lose value due to neglect).

no incentive to maintain the property.<sup>288</sup> In particular, foreclosure laws that permit lost homeowners to retain possession of a property for longer periods can create a problem with property maintenance.<sup>289</sup> Conversely, there is little doubt that abandoned properties are substantially worse for a community.<sup>290</sup> Thus, maintaining homeownership and possession where foreclosure likely will lead to a vacant property is a benefit to the community.

This calculus takes on special significance in the current environment where subprime lending is resulting in a concentration of vacant properties in a community.<sup>291</sup> The geographic concentration of subprime lending has resulted in an overwhelming number of foreclosed properties in neighborhoods with declining property values, which is overwhelming municipal governments attempting to manage the rapidly increasing number of vacant homes.<sup>292</sup> In such circumstances, keeping a homeowner in a deteriorating property is a net benefit to community stability if the alternative is a long period of vacancy.

#### VI. IMPLEMENTING FORECLOSURE REFORM AS HOUSING POLICY

This Article argues for two types of legislative reforms of state foreclosure laws to promote the policy goals identified above. The most direct and substantial reform to achieve these goals is to bifurcate the foreclosure procedure into separate processes for foreclosing loans to homeowners and foreclosing loans to investors and commercial property owners. This Article argues for shorter, less costly foreclosure procedures for investor and commercial property, and longer foreclosure procedures with extended reinstatement rights for homeowners. A corollary proposal is that homeowners should be given incentives to avoid waste to partly address situations where there is no reasonable possibility of either maintaining homeownership or obtaining equity.

A secondary recommendation is a legislative reform of notice procedures to help homeowners better understand and manage

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288. See Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1115, 1117 (1996) (claiming that the longer a foreclosed property remains in the possession of the defaulted mortgagor, the likelier it is that waste and deterioration will occur).

289. See *id.*

290. See *supra* notes 69–79 and accompanying text.

291. See *supra* notes 57–64 and accompanying text.

292. See *supra* note 79 and accompanying text.

their options in foreclosure. This Part also looks at options for implementing the proposed changes, including the difference between these proposals and uniform law efforts.

Some of these proposals would be considered “pro-lender” and others “pro-borrower,” but they share a common purpose of promoting sustainable homeownership and improved neighborhood quality.<sup>293</sup> These goals might also be furthered by other reforms, such as better coordination of local property abandonment law and foreclosure law to reduce the public costs of vacancies.<sup>294</sup> It is housing policy goals that should be the driving force in evaluating foreclosure law reform.

### A. *Bifurcated Foreclosure by Property Type*

Current foreclosure law generally is a one-size-fits-all proposition.<sup>295</sup> The young woman who “invested” in ten residential properties in North Minneapolis and then let them all fall into foreclosure after her partners harvested the fruits of financing is treated the same in foreclosure as a family that owns a home and defaults when one of the parents loses a job due to illness.<sup>296</sup> A separate foreclosure procedure for residential owner-occupied property and other types of properties would allow for the appropriate alignment of incentives to meet broader public objectives. The disproportionate tendency of investor loans to default, as well as the large and increasing share of investor properties in foreclosure, provides urgency to this proposal.<sup>297</sup>

1. *Shorten the Foreclosure Process for Investment Property.* Both of the identified policy goals weigh in favor of expediting foreclosure on residential investment or commercial property. Allowing a lengthy foreclosure process can be justified as a benefit to homeownership only if the borrower is a homeowner. Owners of residential investment property and commercial buildings do not improve homeownership rates by emerging from foreclosure with title to their properties. Nor is there a public interest reason to allow a statutory redemption period for

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293. See, e.g., Halpern, *supra* note 263, at 125 (asserting that promoting homeownership and neighborhood stability are central goals of a national housing policy); Todd & Grover, *supra* note 141 (discussing efforts to increase homeownership rates among minority and immigrant groups in Minnesota).

294. See VACANT PROPERTY, *supra* note 69, at 13; see also APGAR & DUDA, *supra* note 56, at 18–19.

295. See Johnson, *supra* note 211, at 959 (stating that in most states a mortgagor who cannot pay his mortgage must enter into a foreclosure).

296. See *id.*

297. See *supra* notes 160–71 and accompanying text.

residential investment property. From a public policy perspective, even a successful redemption by the investor means that a likely financially marginal investor retains the property.

Borrower protections in foreclosure laws provide property investors the opportunity to own a residential property while disinvesting in it.<sup>298</sup> A judicial foreclosure or other lengthy process can leave the property in the control of the investor for an extended period.<sup>299</sup> Unless the investor is maintaining the property in order to sell it, the investor has little incentive to make sure that the property is maintained during a lengthy foreclosure process.<sup>300</sup> The investor likely will be able to collect rent during the foreclosure procedure while avoiding such investment, as described above with hypothetical investor Jones in State A.<sup>301</sup>

Assuming the property is not abandoned by all parties, there are three types of possible owners after completion of the foreclosure process: the lender or a junior lien holder; a new investor; or a person intending to occupy the property as her residence.<sup>302</sup> Any of these parties is likely better positioned, on the whole, to help achieve public benefits than the defaulting investor-owner.<sup>303</sup> A purchasing homeowner, while perhaps the least likely outcome, would serve the public purpose of increasing homeownership. A new investor seeking to earn income from the property would have, at worst, no less incentive to maintain or improve the property than the investor who let the property proceed to foreclosure. And the investor able to gain financing is likely a more substantial entity than the investor who defaulted on the property. The third option is that the home becomes "REO property," a term used for property held by the lender following foreclosure.<sup>304</sup> Although municipalities have had serious problems with lenders in control of abandoned property, a lender is more

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298. See Schill, *supra* 203, at 534 (asserting that antideficiency laws promote "moral hazard on the part of the borrower" because once the borrower loses his equity he no longer has any incentive to maintain the property; redemption laws create a "heightened risk of waste").

299. See Freyermuth, *supra* note 138, at 5 (stating the judicial foreclosure process takes six months to a year in most states).

300. See Dale W. Cottam & Jack D. Edwards, *Wyoming Foreclosure Law: Conforming to the Broad Changes Made by House Bill 112*, 6 WYO. L. REV. 1, 27 (2006) (suggesting a successful foreclosure bidder should refrain from improving the property until the mortgagor's redemption period is over).

301. See *supra* note 138.

302. See Stark, *supra* note 91, at 234–35.

303. See Schill, *supra* note 203, at 534 (asserting that once a borrower's equity disappears he has no incentive to maintain the property).

304. See RAO ET AL., *supra* note 21.



likely to be a substantial entity with the resources and stability to be held accountable for noncompliance with local regulation of home appearance, such as lawn maintenance, and vacancy control.<sup>305</sup>

Finally, to the extent that an expedited foreclosure process lowers lender costs and thereby results in any benefit to borrowers in the terms of mortgage origination, this result would reduce the costs of residential property ownership and benefit the goal of quality housing. This is especially true given the evidence that lender costs appear to be higher when foreclosing on investor-owned property.<sup>306</sup> A shorter foreclosure period for investors thus would promote either homeownership or rental housing quality and community stability.

2. *Lengthen the Foreclosure Process for Homeowners.* This Article argues for shortening the foreclosure period for investor property, but for the opposite legislative change for homeowners—longer foreclosure procedures through longer reinstatement periods. As a corollary proposal, this Article suggests that states replace redemption rights with a reinstatement right.

a. *Increasing Opportunity for Ownership Retention.* Delay is an end in itself for the foreclosed borrower. For homeowners with the possibility of maintaining ownership, delay provides opportunity. Homeowners who slip into mortgage default through loss of a job have additional time to find new employment. A drop in income and an increase in debt due to illness may be rectifiable with time to heal. A homeowner in these circumstances will also have more of a chance to obtain refinancing after finding new work or otherwise increasing income. Although the benefits of pro-borrower provisions have been woefully understudied, there is some evidence of the effectiveness of longer foreclosure periods in helping homeowners avoid a completed foreclosure.<sup>307</sup> A higher percentage of foreclosed homeowners retaining ownership clearly promotes the

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305. See generally VACANT PROPERTY, *supra* note 69 (discussing the costs of vacant properties to municipalities).

306. Capozza & Thomson, *supra* note 198, at 127.

307. Stark, *supra* note 91, at 243 (finding a twenty-one day period to redeem and an eighteen day period to reinstate the loan deprives borrowers an opportunity to preserve their equity in a property). In the 1994 cases in the Empirical Study, the median period to redeem was four months, and in the 1993 cases the median period to redeem was nine months. *Id.*

sustainable homeownership goal that should be driving foreclosure reform.

A more subtle benefit would occur from the incentives for lenders to engage in a workout rather than complete the foreclosure. As the study by Clauretie found, states with more lengthy foreclosure procedures have lower foreclosure rates.<sup>308</sup> Lenders facing longer reinstatement periods for homeowners will have more interest in pursuing options to avoid the foreclosure process, including loan modifications and forbearance to retain ownership for the defaulting homeowner.<sup>309</sup>

Delay also works to the benefit of homeowners with home equity wanting or needing to sell their homes.<sup>310</sup> In states with rapid power of sale procedures, homeowners have less opportunity to market the property.<sup>311</sup> In such states, the homeowner must make a quick determination that selling the property is the best alternative, find an agent to list the property (or try to sell it herself), and hope that the property sells and closes quickly enough to beat the foreclosure sale date.<sup>312</sup> An impending foreclosure sale can make it harder to sell the home.<sup>313</sup> A lengthened foreclosure process combined with the suggested reforms to notice procedures would allow homeowners a better chance to sell their home prior to the public announcement of a foreclosure sale.<sup>314</sup>

b. Lengthen Reinstatement Periods. An extended reinstatement period is the best method of creating opportunities afforded to homeowners by delay. In all states, an extended reinstatement period would mean more homeowners would be likely to reinstate because of the lower barriers to a partial refinance.<sup>315</sup> A homeowner seeking to maintain ownership would have the best chance at new financing because the homeowner would only need to arrange a junior lien loan to pay off the amount of arrears, rather than obtain a refinance loan for the full amount of the mortgage loan.

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308. *Id.* at 242–43.

309. *Id.*

310. *Id.* at 232.

311. See Stark, *supra* note 18, at 685 (noting that a power of sale can be structured to take only two to four months).

312. See Johnson, *supra* note 211, at 974–75.

313. See *id.*

314. See Stark, *supra* note 91, at 242–43 (asserting that federal legislation deprives borrowers an opportunity to save their homes by only providing eighteen days to reinstate the loan).

315. *Id.*

Consider an example. Assume a homeowner lives in a state with a judicial foreclosure process that takes a minimum of ten months after the initial foreclosure notice: New Jersey, for example.<sup>316</sup> The first lien mortgage in foreclosure is at an 8% interest rate. The homeowner has defaulted due to an extended period of unemployment, but finds a well-paying job four months into the foreclosure process. The homeowner now has the income for a possible refinance and, due to the equitable right of redemption in every state, has the right to pay off the entire balance of the loan prior to completion of the foreclosure. But due to her mortgage default, the refinance would be at a 13% interest rate, which results in unaffordable monthly payments. A right to reinstate would make it possible for the homeowner to obtain a higher rate second mortgage to cure the arrears but retain the lower cost primary mortgage. Homeowners simply avoiding the crushing reality of foreclosure and who delay seeking help with the problem also would benefit from the lower burdens imposed by reinstatement.

A lengthy reinstatement period would be easy to implement in most judicial foreclosure states by creating a statutory right to reinstate until the time of the foreclosure sale, or shortly before that date. Judicial foreclosure generally is preferred by advocates for borrowers primarily because it creates delay.<sup>317</sup> The more significant change would have to occur in most power of sale states, where an extended reinstatement would mean lengthening the existing foreclosure period.<sup>318</sup>

For states with redemption periods, it especially makes sense to replace redemption rights with a period for reinstatement. Redemption periods force the homeowner with options into a refinance of the entire loan balance while still imposing the cost of delay on the lender.<sup>319</sup> Unlike the extension of reinstatement rights in states with short foreclosure periods, there is little cost to the lender involved in exchanging a redemption right with a reinstatement right.<sup>320</sup> The length and cost of the foreclosure process is the same. The two differences for the lender are: (1) some homeowners will reinstate rather than

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316. MORTGAGE DIRECTORY, *supra* note 19, at 1-199-203.

317. See Stark, *supra* note 91, at 232 (suggesting that borrowers prefer judicial sale because the longer period of time gives a greater opportunity to redeem or reinstate).

318. *Id.* at 243 (suggesting that a longer reinstatement period would allow borrowers to save their homes from foreclosure).

319. See Schill, *supra* note 203, at 496-97 (stating that mortgagor protection laws create high costs but also give mortgagors time to recover from financial difficulty).

320. See Clauretie, *supra* note 203, at 547 (asserting that state laws which slow the foreclosure process increase lender's costs).

redeem; and (2) some homeowners will reinstate rather than let the lender or a junior lien holder obtain full ownership and possession rights at the end of the redemption period.<sup>321</sup> Increased reinstatements in place of redemptions may or may not be considered beneficial from the lender's perspective, depending on whether the lender views the particular loan as profitable. Yet, the lender will not suffer substantial loss on the loan and thus sustains no significant burdens. The latter consequence, reinstatements rather than homeownership loss, will be a benefit to the lender if the property is worth less than the loan amount plus lender resale costs.<sup>322</sup> If the property has a surplus that could be realized by the lender or a junior lien holder, reinstatement will deprive the lender of that benefit, but this surplus should belong to the homeowner in any case.

An additional advantage of replacing the redemption period with reinstatement is that it will make the foreclosure sale potentially more meaningful for the occasional borrower who maintains equity in the home at the end of the foreclosure process. In a state with a redemption period, the incentives align to make it inevitable that the lender will almost always make a successful credit bid of the amount owed at the foreclosure sale.<sup>323</sup> The homeowner then either redeems the property or loses any possibility of retaining equity at the end of the process. Eliminating the redemption period in favor of reinstatement would move the sale to the end of the foreclosure process and afford the possibility of the homeowner retaining some equity after the sale.

*3. Objections to Extended Reinstatement Rights for Homeowners.* Commentators have questioned whether homeowners should receive any preference in foreclosure procedures.<sup>324</sup> Common objections to extending the length of the foreclosure procedures for homeowners are the costs imposed on lenders by delay and the possibility of waste to the property during an extended foreclosure period.<sup>325</sup> This Section addresses these objections.

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321. Stark, *supra* note 91, at 234 (explaining that the mortgagor has both the right to redemption and the right of reinstatement).

322. Ambrose & Capone, *supra* note 146, at 106–09 (setting forth the instances in which lenders will consider foreclosure alternatives).

323. See Nelson & Whitman, *supra* note 91, at 1423 (exhibiting how foreclosure sales will frequently only fetch “full credit bids”).

324. Les Christie, *Major Lenders Put Freeze on Foreclosures*, CNNMONEY.COM, Feb. 12, 2008, [http://money.cnn.com/2008/02/12/real\\_estate/foreclosure\\_freeze/index.htm](http://money.cnn.com/2008/02/12/real_estate/foreclosure_freeze/index.htm).

325. See Pence, *supra* note 203, at 177 (indicating that lenders in states with friendly mortgagor laws have higher costs).

a. Disinclination to Preferences for Homeowners. Although no state has a wholly distinct foreclosure process for residential homeowners, a few state foreclosure laws have some additional rights that apply only to these borrowers.<sup>326</sup> The most recent uniform law proposal, the UNFA, has a variety of provisions that only apply to residential debtors, including additional notices and the right to request a meeting with the lender to raise objection to the foreclosure.<sup>327</sup>

Scholars have generally treated the notion of protections for homeowners as a cheap trick of political expediency.<sup>328</sup> Johnson states that foreclosure laws designed to best enable protection of homeowner equity are motivated by politicians who engage in “castigating banks and financial institutions for profiting on the misery of poor, desperate homeowners . . . [who] vote.”<sup>329</sup> Nelson and Whitman, although less cynical, generally are not sympathetic to treating residential homeowners differently than investors in rental property or owners of commercial property:

It is not entirely clear that there is a sound basis for this distinction between residential and commercial debtors. . . . But the political appeal of providing extra protections to residential borrowers cannot be denied. There are a large number of residential borrowers, and they vote. . . . UNFA contains a number of special protections for residential borrowers, many of which were included with an eye toward “enactability.” In essence, these provisions make the Act more politically attractive. This is not to say that the special protections lack a sensible policy basis. On the contrary, perfectly plausible arguments can explain most of them.<sup>330</sup>

These objections to, or lukewarm sentiments toward, different protections for homeowners reflect a view of foreclosure law as designed solely to balance competing interests between borrowers and lenders; specifically, a lender’s interest in the most cost-effective means of selling its collateral and a borrower’s interest in obtaining any equity remaining in the property.<sup>331</sup>

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326. See Nelson & Whitman, *supra* note 91, at 1447 (noting example state foreclosure laws with protections for residential homeowners).

327. See UNFA, *supra* note 96, at 7–8.

328. See Johnson, *supra* note 211, at 960 (suggesting that historical data exists showing political reaction to the economy of the times).

329. *Id.* But see Schill, *supra* note 203, at 515–16 (setting forth the notion that owners need protection based on worse information / risk assessment).

330. See Nelson & Whitman, *supra* note 91, at 1447–48.

331. See Stark, *supra* note 18, at 660–61.

The argument in this Article proceeds from a different premise—that the structure of the foreclosure process affects social outcomes, and that the law should be constructed to promote national housing goals, as well as reflect the normative preference of each state in balancing borrower and lender interests. Homeowners do not have to be portrayed as more innocent of misconduct than lenders to justify a foreclosure law that provides homeowners more rights. Greater rights for homeowners under foreclosure law, as opposed to investors, benefits our collective interests in sustainable homeownership and community quality. As a policy matter, elected officials act consistently with public policy goals when providing greater rights to homeowners in foreclosure, whatever their motivations.

b. *Costs of Lengthy Reinstatement Rights.* Longer foreclosure periods mean costlier foreclosures for lenders.<sup>332</sup> The delay created by a longer reinstatement period undoubtedly increases the costs of the foreclosing lender in states with more rapid foreclosure processes.<sup>333</sup> Economists and legal scholars tend to frame the issue as weighing the impact of increased foreclosure costs on new mortgage loan originations against benefits to homeowners attempting to preserve ownership or equity in foreclosure. At best, this is a question that might be substantially informed by empirical research. Current research is inconclusive on the effects of foreclosure law on mortgage origination and almost nonexistent on the benefit of borrower protections in preserving homeownership.

This cost-benefit analysis misses an important gain from higher foreclosure costs in cases involving homeowners. Particular lending practices, especially with recent subprime lending, are known to be associated with increased foreclosures.<sup>334</sup> Higher foreclosure costs provide incentives to

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332. Some borrowers arguably might abuse the reinstatement right by repeatedly entering foreclosure and then reinstating the loan near the end of the foreclosure process. Borrowers with any equity or interest in building equity in the property have little incentive to engage in this practice because the costs of foreclosure are substantially shifted to the borrower. In any case, legislatures can limit the right of reinstatement or redemption to prevent repeated use by a borrower. Some states have such a provision limiting the right of reinstatement or redemption. *See, e.g.*, ALASKA STAT. § 34.20.070(b) (2006) (limiting right of reinstatement in Alaska to two opportunities).

333. This objection is true only in power of sale states without a long redemption period; in other words, in states with a short foreclosure process for homeowners. In states with judicial foreclosure or long redemption periods, extending the statutory right to redeem will not impose the costs of delay.

334. *See supra* notes 43–44 and accompanying text.

lenders to avoid or limit practices that result in foreclosure.<sup>335</sup> This calculation is already occurring as to mortgage origination practices in the subprime industry,<sup>336</sup> and increased foreclosure costs will provide further disincentives to engage in practices likely to lead to foreclosure.<sup>337</sup> If higher foreclosure costs adversely affect loan origination practices so as to slightly restrict credit availability and homeownership, then higher foreclosure costs logically would restrict lending practices most likely to result in foreclosure.<sup>338</sup> Such a result benefits the goal of sustainable homeownership.

Return to Karen Pence's assertion that longer foreclosure procedures are "foreclosing opportunity" for mortgage borrowers in judicial foreclosure states by reducing loan amounts.<sup>339</sup> Even if Pence is correct that longer foreclosure periods result in a slight aggregate decrease in mortgage loan amounts, this consequence could just as likely be a healthy outcome for sustainable homeownership.<sup>340</sup> Subprime loans for the full amount of the market value of the house, known as 100% loan-to-value mortgages, have been strongly associated with foreclosure risk.<sup>341</sup> If longer or most costly foreclosure procedures result in greater prudence by lenders as to the type of loans that are more likely to end in foreclosure, that result is a social benefit from "pro-borrower" foreclosure provisions.<sup>342</sup> Additional loan volume is not a justification for allowing lenders to impose on society the costs of mortgage lending failure.

c. The Problem of Waste and Homeowner Incentives. Another objection to longer reinstatement periods is that lost homeowners will have no incentive or capacity to maintain their homes during this extended foreclosure period. Ideally,

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335. Brendan McDonagh, CEO, HSBC Fin. Corp., Testimony Presented to the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 22, 2007) (transcript available at [http://banking.senate.gov/public/\\_files/mcdonagh.pdf](http://banking.senate.gov/public/_files/mcdonagh.pdf)).

336. See ZELMAN ET AL., *supra* note 45, at 56.

337. See *id.* at 1.

338. See *id.* at 6.

339. See Pence, *supra* note 203, at 177–180.

340. *Id.* at 180.

341. See ZELMAN ET AL., *supra* note 45, at 1; see also Dale Westhoff, Senior Managing Dir., Bear Stearns, Subprime Spillover, Presentation at JPMorgan Conference, Repricing Subprime Mortgage Credit: Assessing the Fallout (Mar. 9, 2007).

342. See Governor Edward M. Gramlich, Subprime Mortgage Lending: Benefits, Costs, and Challenges, Remarks at the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004) (transcript available at <http://www.federalreserve.gov/boarddocs/Speeches/2004/20040521/default.htm>) ("[F]urther social benefits would result if various institutions could agree on and implement changes that would lower foreclosures.").

homeowners entering foreclosure could be sorted efficiently into one of the three primary categories previously described: those with a reasonable chance to maintain ownership; those with equity but no chance to maintain ownership; and lost homeowners. The lost homeowners could be foreclosed through an expedited procedure.<sup>343</sup> Unfortunately, this triage exists only in theory, as there is no cost-effective and fair means for such a sorting determination. Providing incentives to such homeowners for early termination and loss mitigation would ameliorate this concern.

Several scholars have suggested addressing the problem of lost homeowners through a form of mandatory sorting, typically by appraisal that would separate homeowners with equity from those without equity.<sup>344</sup> This proposal fails to address either the limits of the sorting mechanisms or the costs and fairness of the procedure.

Homeowners who owe more than the fair market value of the house may still have both personal and economic reasons for attempting to maintain ownership of their homes.<sup>345</sup> Personal attachments to the home or community motivate some homeowners to maintain ownership even if the rational financial choice is to abandon the property.<sup>346</sup> Homeowners also have economic reasons for trying to maintain homes in which they have no equity. A homeowner very likely will not be able to obtain financing for a new home after his or her credit is seriously damaged by the foreclosure.<sup>347</sup> Losing the home in foreclosure means little possibility of homeownership for years.<sup>348</sup> Unless the sorting mechanism includes the daunting task of evaluating a homeowner's ability to payoff, reinstate, or redeem the home, sorting by equity will mean the loss of ownership for

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343. While it may make sense in a normal period of mortgage financing to shorten the foreclosure period for homeowners with no equity and no chance to maintain the home, homeowners caught in the subprime mortgage meltdown likely present an exception. Such homeowners were so often the victim of unfair or predatory lending, it can be argued that states should not be allowing routine foreclosure of all such mortgages.

344. See *supra* notes 213–34 and accompanying text; see also Jacoby, *supra* note 90, at 331–38 (suggesting that Chapter 13 could be a base model for such a sorting system).

345. DESIREE HATCHER, FORECLOSURE ALTERNATIVES: A CASE FOR PRESERVING HOMEOWNERSHIP 2 (2006), available at [http://www.chicagofed.org/community\\_development/files/02\\_2006\\_foreclosure\\_alt.pdf](http://www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf) (detailing effects of foreclosure on homeowners).

346. THERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 203, 230–31 (2000).

347. See HATCHER, *supra* note 345, at 2.

348. Also, transaction costs change the calculus of equity in the home. The cost of moving and other relocation expenses makes it economically rational for some homeowners to attempt to save a home.



homeowners who could have saved their homes in foreclosure despite having little or no equity in the home.

The appraisal sorting proposals have a second problem. The costs of using an independent party to sort borrowers are not given much consideration in these proposals. Homeowners presumably would be given the right to object to the value determination, thus further increasing the costs of the procedure. The right to object is especially important if the appraisal is conducted at the direction of the foreclosing lender. Inaccurate appraisals and lender conflicts of interest in pressuring appraisers have been a subject of concern with the recent subprime lending problems.<sup>349</sup>

It is possible to mitigate some of the consequences resulting from lost homeowners in foreclosure. The UNFA provides a well-considered approach to the problem of waste with these homeowners.<sup>350</sup> It permits an action for a deficiency judgment against a homeowner only if the lender can establish that the debtor did not act in good faith and that this conduct by the debtor caused "significant loss or damage to the foreclosing creditor or the collateral."<sup>351</sup> A presumption of lack of good faith can be established by the lender proving that the homeowner failed to peaceably vacate the property, failed to take precautions against damage to the property by others or by natural causes, or three other express circumstances.<sup>352</sup> While the value of this provision for lenders may be limited by the necessity to bring an action and prove certain conduct by the homeowner, the existence of the duty might provide homeowners an incentive to take actions to prevent waste to the property.<sup>353</sup>

Another approach to this problem would be to put the burden on the homeowner to obtain the right to an extended reinstatement period. A homeowner could be required to file a form indicating that she occupies the home as a primary residence and that she is actively seeking to cure the default or arrange a solution to the foreclosure. A more stringent model could tie the extended reinstatement right to a certification by a licensed foreclosure prevention counselor that the homeowner has a plan that has a realistic possibility of succeeding in

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349. See STATE FORECLOSURE GROUP, *supra* note 130, at 5; Federal Reserve Board Proposed Rule Comment, 73 Fed. Reg. 1671, 1700-02 (proposed Jan. 9, 2008) (discussing widespread concerns with coercion of appraisers in home mortgage lending).

350. See UNFA, *supra* note 96, at 2.

351. *Id.* at § 607(b)(2).

352. *Id.* at § 607(c).

353. *Id.* at § 607 cmt.

preventing the completion of the foreclosure. Adopting a burden on homeowners to secure extended rights would require careful attention to effective notice procedures and available independent counseling assistance.

4. *Defining Property Types in a Bifurcated System.* Bifurcating foreclosure laws in the manner proposed here raises the practical issue of creating a workable definition of the different property types. The lender must be able to effectively identify owner-occupied homes among the properties it seeks to foreclose. Although numerous states have some form of specific protections or rights afforded to homeowners with accompanying definitions, the UNFA provides a good starting point. It provides homeowner protections for an individual who owns a one-to-four unit property that “is used or is intended by its owner to be used primarily for . . . personal, family or household purposes.”<sup>354</sup>

A problem with the UNFA definition is that it defines the personal use limitation in terms of the situation or intent of the owner at the time the mortgage is originated.<sup>355</sup> The UNFA definition provides a discernible bright line for the foreclosing lender, but fails to capture borrowers who start out as homeowners and later convert the property to rental, investors who later convert the property to their residence, or borrowers who purposefully deceive the lender about the occupancy status at loan origination.<sup>356</sup> This omission could be remedied by allowing the borrower or the lender to provide a notice that the property’s use has changed since the use designated at origination. This notice procedure could be accompanied by an appeal procedure and consequence for bad faith use or appeal, such as penalties and attorney’s fees, or even criminal sanctions.

#### B. *Notices to Homeowners*

Foreclosure notice procedures would be generally recognizable to real estate attorneys from the 1930s. Legislative change could make the system more transparent and understandable to homeowners, and increase the likelihood they could preserve their ownership. This section proposes two

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354. *Id.* at § 102 (16)–(17). The UNFA definition is somewhat broader in that it includes property owned by an artificial entity, such as a trust or corporation, if the entity is controlled by the individual who otherwise would qualify as a residential debtor. As the Comment to section 102 correctly notes, “personal, family or household use” is a commonly used phrase in both federal and state consumer protection laws. *See id.* at 16.

355. *See id.* at 11.

356. *See Nelson & Whitman, supra* note 91, at 1449.

changes in notice procedure. First, the timing and content of notices should be constructed to disclose useful information to homeowners, such as sources for homeowner assistance. Second, there should be a delay in initial public notice of foreclosure to allow for homeowner education prior to solicitation by foreclosure buyers.

1. *Plain Language Homeowner Assistance Notices.* The current system of notice service and advertisement requires or permits notices that are incomprehensible to many homeowners.<sup>357</sup> Foreclosure notices often contain lengthy legal descriptions of the property but omit the street address, use terms like “mortgagee” or “pursuant,” and generally make little sense to most homeowners, or are intimidating to them. Even the exemplar model Notice of Default under the UNFA, which would not be a required format or language under the uniform law, is less than easily digestible for unsophisticated homeowners.<sup>358</sup>

More importantly, homeowners entering foreclosure need to know more than that they are in foreclosure. They need to know all of their options for confronting the possible loss of their home, including the possibilities of a loan workout. Half or more of homeowners in foreclosure are unaware of basic options available to them.<sup>359</sup> Foreclosure laws should be reformed to require lenders to send multiple informational notices to homeowners facing foreclosure.

A simple and prominent series of notices directing homeowners to a listing of such services could be of practical assistance for many.<sup>360</sup> Homeowners could be sent information outlining the potential for loan workouts, contact information for pursuing a loan workout, the steps of the foreclosure process in that state, and options typically available to homeowners. Even if counseling services are not readily available in the area in which the home is located, this information could be useful to

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357. George Hathaway, *Plain English in Real Estate Papers*, 72 MICH. B.J. 1308, 1310 (1993) (criticizing foreclosure notices for not being written clearly).

358. See UNFA, *supra* note 96, at § 202. For example, a part of the model Notice of Foreclosure states: “If completed, the foreclosure will terminate your rights in the property unless First Financial Corp. elects to send you a notice stating that your rights are being preserved.” *Id.* at 44.

359. See *supra* notes 180–82 and accompanying text.

360. Minnesota, for instance, has since 2004 required a single “foreclosure advice notice” be provided with every communication about the foreclosure sent to a residential owner-occupant. MINN. STAT. ANN. § 580.041 (West 2000 & Supp. 2008). The notice must contain statutorily required language, be on its own page of separately colored paper, and conform to other requirements for prominence of disclosure. *Id.*

homeowners in determining their options in foreclosure.<sup>361</sup> Unlike origination of the mortgage, when the homeowner is overwhelmed with paper and the disclosures seem of remote consequence, some homeowners in foreclosure are intently focused on the documents received during the process. This information could be provided in the form of a DVD with multiple language options, as a brochure or booklet, or as a series of individual notices.

These notices could be timed to meet the likely needs or issues facing homeowners at the time in the foreclosure process that the notice is delivered. For instance, if the UNFA deficiency judgment provisions were enacted, some of the notices in the latter part of the foreclosure process could be targeted to describing the disincentives for homeowners to allow or engage in property destruction or deterioration.

Simple, repetitive, and timely notices designed to direct homeowners to counseling assistance or informing them of their options in foreclosure would impose no significant costs on the foreclosing lender. By improving the chances that a homeowner would understand her rights or seek assistance in negotiating the foreclosure process, such notices would promote sustainable homeownership with little costs to any other housing policy goal.<sup>362</sup>

2. *Nonpublic Notice of Default to Public Entities.* The second suggested reform of foreclosure notice requirements is aimed at engaging public entities and non-profit organizations in the process and at protecting the homeowner from fraud. Foreclosing lenders should be required to file notices of default with an appropriate public entity, but public disclosure of these notices should be delayed.

While the current notice system varies tremendously by state, almost all states require some form of public recording or advertisement of the foreclosure prior to the sale. In many power of sale states, this notice is the first public record of the existence of the foreclosure. The proposed notice system in the UNFA

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361. See U.S. Department of Housing and Urban Development (HUD), Tips for Avoiding Foreclosure, <http://www.hud.gov/foreclosure/index.cfm> (last visited Sept. 5, 2008).

362. Notices during the foreclosure process must also serve the formal legal purpose of ensuring that borrowers are made aware of the existence of the action. See Mattingly, *supra* note 97, at 92–94. In a judicial foreclosure state, such foreclosure notices must contain information that would allow an attorney for the borrower to defend. While important for the few homeowners who can obtain counsel, there is little practical value to a homeowner.

includes a Notice of Default and right to cure followed no less than thirty days by a publicly recorded Notice of Foreclosure.<sup>363</sup> In judicial states, the foreclosure action is initiated by a public court filing.<sup>364</sup> In all states, public or nonprofit counseling agencies, whose purpose is to assist homeowners, receive no advance notice of the foreclosure before public recording or advertisement of the foreclosure proceeding unless the homeowner seeks out such assistance while in default but prior to initiation of foreclosure.

Lenders could be required to file the Notice of Default with a designated public entity when homeowners reach sixty or ninety days delinquent on their mortgages.<sup>365</sup> The public entity would hold the notice for days or weeks prior to publicly recording the notice or otherwise making the fact of default available to the public. For states that are interested in developing a comprehensive strategy to ameliorate the current wave of foreclosures, this early notice would allow public agencies to directly contact homeowners or provide the information to nonprofit counseling agencies. Consumer-friendly notices to homeowners from a source other than the lender may prompt a certain percentage of them to contact their lender to explore a workout or seek counseling assistance. Early intervention by counseling agencies could have an impact on homeownership retention rates.

An important component of this early notice system would be the delay between this notice and public access to information about homeowners in foreclosure.<sup>366</sup> Homeowners in foreclosure are besieged by direct mail, phone calls, and personal solicitations as soon as the foreclosure becomes public. A substantial problem for homeowners with equity is falling victim to a foreclosure rescue scam perpetrated by one of these solicitors and losing both title to the property and the remaining equity.<sup>367</sup> At least five states have passed laws in the last three years designed to severely restrict transactions with foreclosed

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363. UNFA, *supra* note 96, at § 202.

364. NELSON & WHITMAN, *supra* note 100, at 559–60.

365. States could also require that the notice be filed electronically and include some basic information about the homeowner, if known to the lender, such as the amount of the loan balance and arrearage. A more sophisticated program might include solicitations in the language of the homeowner or targeted solicitations based on the data from the lender and public records that would provide a gauge of whether there is equity in the property or the likelihood of a workout arrangement.

366. This proposal would impact and may require changes in each state's data practices laws to clarify the public or nonpublic status of the filed foreclosure notice data.

367. RAO ET AL., *supra* note 21, at § 15.1, §§ 15.2.1–2.3; Cox, *supra* note 191, at 607.

homeowners that usually lead to this result.<sup>368</sup> Providing public or nonprofit agencies a period of advance notice could help educate homeowners about the dangers of foreclosure rescue scam solicitations.<sup>369</sup>

### C. Implementation of Foreclosure Reform

The history of foreclosure reform is a series of failed attempts to enact uniform laws generally designed to make foreclosure less costly for lenders and improve sale procedures.<sup>370</sup> A decentralized and public policy-based approach is more likely to be enacted, as well as be better designed to achieve results that will promote housing policy goals.

Numerous commentators have advocated uniformity in foreclosure procedures to accompany the increasing national or even global character of real estate finance markets.<sup>371</sup> Writing in 1996, Patrick Randolph Jr. stated: "Political and market conditions now indicate that we will have universal private foreclosure laws across the nation in the relatively near future."<sup>372</sup> Twelve years later, the "near future" of 1996 has not remotely taken shape.<sup>373</sup>

Uniform foreclosure law efforts, such as the ULSIA and UNFA, ask too much of state elected officials. For most states, uniform laws require the abandonment of existing foreclosure procedures familiar to those involved in matters of local real estate, including realtors, real property attorneys, the courts, and others.<sup>374</sup> The promoted advantage of this radical reform is that it will be more efficient for lenders to foreclose and that national uniformity will reduce the costs of lenders engaged in

368. See Johnson, *supra* note 211, at 961. Adopting changes to foreclosure notice procedures would be part of a comprehensive legislative structure for controlling foreclosure equity stripping.

369. Another advantage of this proposal is that it provides homeowners with equity who are attempting to sell the property more time do so before potential buyers are aware that the homeowner is in foreclosure—a fact which can discourage buyers and depress prices.

370. See *supra* note 96.

371. See Nelson & Whitman, *supra* note 91 at 1415; see, e.g., Ann M. Burkhart, *Real Estate Practice in the Twenty-first Century*, 72 MO. L. REV. 1031, 1036 (2007).

372. See Randolph, *supra* note 288, at 1110.

373. Uniform Law Commissioners Facts, A Few Facts About the Uniform Nonjudicial Foreclosure Act (2002), [http://www.nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-unfa.asp](http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-unfa.asp) (last visited Sept. 5, 2008) (indicating that no states have adopted the UNFA).

374. See Randolph, *supra* note 288, at 1112. Today, these institutions, including title insurers, local lenders, appraisers, and brokers, regard with suspicion and distrust proposals for sweeping reforms that would do away with the many specialized rules.

securitization of mortgages.<sup>375</sup> Local pain for alleged global gain is rarely a recipe for substantial law reform.

There are other barriers to a national policy of foreclosure reform. Regulation of real estate is a quintessentially local matter. Globalization in the secondary market for United States real estate finance investments does not change the reality that the secured property sits permanently in a locale. It is the local sheriff's office that will ultimately evict some of the homeowners who cannot escape foreclosure. The current wave of foreclosures driven by securitized subprime loans provides little incentive to elected officials to ease the burden on lenders from varying state foreclosure laws while local communities are attempting to cope with the community devastation wrought by the practices of these lenders.

Many state legislatures are grappling with foreclosure law reform as states face this explosion of foreclosures.<sup>376</sup> A state could adapt pieces of the proposals in this Article and the UNFA as they fit the unique configuration of foreclosure procedures and protections, as well as the normative preferences, of that state. A state with a history of borrower protections, like Illinois, may want to adopt more rapid foreclosure for property investors, yet include small businesses or farmers along with residential homeowners in the group benefiting from longer foreclosure procedures. A state more familiar with a rapid power of sale procedure and no redemption period, like Texas, may want to extend reinstatement rights for homeowners for a short period, perhaps an additional three months, and offer only a partial deficiency protection for early foreclosure termination. In short, an incremental approach to foreclosure reform is more likely to lead to reforms that make a difference for public policy goals that are affected by state foreclosure laws.

## VII. CONCLUSION

Foreclosure law affects individual borrowers and lenders, but it also makes a difference in how our communities cope with the collapse of subprime mortgage lending. This Article focuses on sustainable homeownership and community stability and quality as outcomes that should drive changes to foreclosure

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375. See Nelson & Whitman, *supra* note 91, at 1399.

376. Office of State–Federal Relations, Nat'l Conf. of State Legislatures, Floor Alert (May 6, 2008), [http://www.ncsl.org/statefed/FloorAlert\\_Mille\\_LaTouretteAmendment.htm](http://www.ncsl.org/statefed/FloorAlert_Mille_LaTouretteAmendment.htm) (urging state legislative support for a bill which would curb abusive foreclosure practices); see also Nicholas Confessore & Jeremy W. Peters, *A Plan to Help Stem Foreclosures, but No Moratorium*, N.Y. TIMES, June 20, 2008, at B3.

laws. Bifurcating foreclosure procedures, with greater protections for residential owner-occupants and an expedited process for foreclosing investor-owned property, would promote both sustainable homeownership and community quality. Improving notice procedures for homeowners in foreclosure would increase the likelihood of borrowers maintaining ownership.

The devastation caused by a decade of escalating subprime lending will force foreclosure reform onto the agenda of state legislatures. That debate should proceed from a policy basis that focuses on the consequence of changes for our shared concerns with housing quality and ownership. National housing policy goals, however construed, should drive foreclosure law reform.



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